UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

INTERNATIONAL MONETARY AND FINANCIAL ISSUES FOR THE 1990s

Volume II

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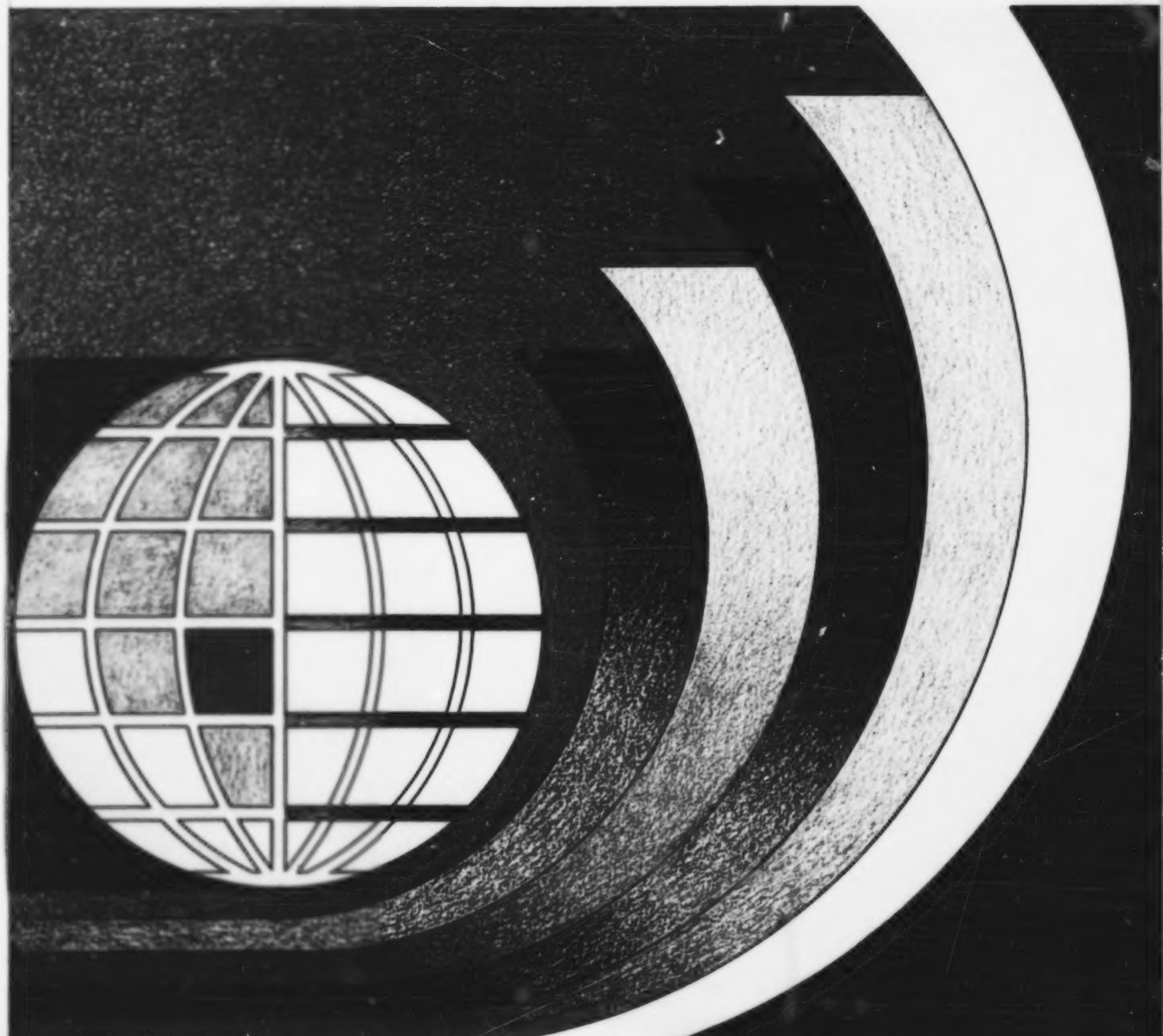

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INTERNATIONAL MONETARY AND FINANCIAL ISSUES FOR THE 1990s

Research papers for the Group of Twenty-Four

VOLUME II

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Introduction

The Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24) was established in November 1971 to increase the negotiating strength of the developing countries in discussions that were going on at that time in the International Monetary Fund on reform of the international monetary system. Developing countries felt that they should play a meaningful role in decisions about the system, and that the effectiveness of that role would be enhanced if they were to meet regularly as a group, as the developed countries had been doing for some time in the Group of Ten (G-10).

It soon became apparent that the G-24 was in need of technical support and analysis relating to the issues arising for discussion in the Fund and Bank, including the Interim and Development Committees. In response to representations by the Chairman of the G-24 to the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD), and following discussions between UNCTAD and the United Nations Development Programme (UNDP), the latter agreed in 1975 to establish a project to provide the technical support that the G-24 had requested. This was to take the form, principally, of analytical papers prepared by competent experts on issues currently under consideration in the fields of international money and finance.

Mr. Sidney Dell, a former Director in UNCTAD's Money, Finance and Development Division and subsequently Assistant Administrator of UNDP headed the project from its establishment until 1990. During this period, some 60 research papers were prepared by the Group of Twenty-Four. The high quality of this work was recognized by the Deputies and Ministers of the Group and the reports were given wide currency, some being published in five volumes by North-Holland Press and others by the United Nations.

The project work was resumed in 1990 under the direction of Professor G.K. Helleiner, Professor of Economics, University of Toronto, Toronto, Canada. The UNCTAD secretariat continues to provide both substantive and administrative backstopping to the project. Funding is presently being provided by the G-24 countries themselves, the International Development Research Council of Canada and the Government of the Netherlands. As a result, it has been possible to continue to provide the Group of Twenty-Four timely and challenging analyses. These studies are being reissued periodically in compendia. This is the second volume to be published.

PROSPECTS OF FINANCIAL FLOWS TO DEVELOPING COUNTRIES IN THE 1990S: THE GLOBAL MACROECONOMIC TRADE-OFFS

Rob Vos

Executive Summary

Recent developments in the world economy seem to indicate that access to international capital flows will remain difficult for most poor countries in the immediate future. The concern is about a presumed decline in the global savings availability associated in particular with declining savings rates in the major economies (G-7) where the bulk of global financial resources is generated. A reduced supply of global savings must meet an increased demand for investment resources in the 1990s. Capital demands are expected to remain high in the major economies themselves, while large new capital demands are being projected for the economic transformation in Eastern Europe and the Republics of the former Soviet Union, for the reconstruction in the Middle East after the Gulf war and for action programmes to save the global environment. The availability of funds for the developing countries may be 'crowded out' by these new demands for global savings. Alternatively, since ex-post global savings and investment should balance, attempts to satisfy all these demands (including demands for increased capital flows to developing countries) will trigger a global adjustment process which is likely to lead to higher world interest rates affecting economic growth and trade in both rich and poor countries.

Despite a recovery of savings rates in some industrial countries, concerns about reduced availability of global savings in the medium run seem justified. Demographic factors predict falling private savings rates in the major economies. Public savings in the large economies are being eroded by the accumulation of public liabilities. This has been undermining even further the responsiveness of national savings to adjustments in the global interest rate. The response of private savings to interest rates was assessed to be rather low, while rising interest rates will reduce government savings where public debt is large. The implication for the world economy is that each exogenous shift in the global demand for investment resources, for instance an increase in capital transfers to the developing countries, will require a large interest rate adjustment to restore global capital market equilibrium and will crowd out investment elsewhere.

Many estimates have been given of the capital requirements of developing countries in the 1990s. The methods used to derive these estimates are limited and only cover partial effects. Leaving these methodological limitations aside, the resulting LDC capital requirement estimates are large enough to have a major impact on the world economy. This implies that proposals to raise capital transfers to developing countries will have to take account of global repercussion effects. The direct effect of additional capital inflows may be higher investment and growth in the recipient countries, but at the same time they could lead to rising world interest rates which will enhance debt-service burdens and reduce investment demand and growth in the industrial countries. The latter effect will then spill over to commodity markets and reduce demand for developing country exports.

An assessment of these effects using global trade and macroeconomic models confirms the importance of these repercussions. If additional capital transfers take the form of official development assistance, the effect is like a fiscal expansion in the industrial countries. If this fiscal expansion is financed by increasing public debt the (short- to medium-run) global recessionary consequences may be severe, even to the extent that what is gained through higher capital inflows is (more than) offset by a loss of export earnings. The key to a more stable global adjustment process seems to lie in adequate fiscal adjustment in the North. Northern governments should thus trade off increased aid transfers against other government expenditures.

The workings of the global capital market do not provide developing countries with easy access. Additional transfers will have to come largely from official sources. For most developing countries, private capital markets are still (or always have been) cut off. The recent growth of foreign direct investment and portfolio investment flows has been restricted to a very small group of the larger and richer developing countries. There is scant reason to believe that this renewed access to private capital markets would be spread very widely. At the same time, however, private

agents throughout the developing world have accumulated large foreign asset holdings. However, the mobilization of these funds for domestic development will not be easy. Experience in countries where debt conversion programmes worked to repatriate this 'flight capital' indicates that monies did return after a sustained period of successful adjustment. External finance required for the process of stabilization and adjustment will have to come from official sources. A major part of the developing world is still caught in this process and, in the light of the previous conclusions, will be dependent on budgetary decisions made by the Governments in the industrialized countries.

The existence of elaborate global model(s) thus seems essential to assist international policy analysis. A number of global macroeconomic models is available, but the modelling of the financial linkages between industrial and developing countries is still rather rudimentary with little detail and differentiation with regard to the LDCs. More research will have to be invested in this area.

Introduction

Net resource flows to developing countries contracted sharply after 1982. At the start of the 1990s, prospects for financial flows to these countries still looked gloomy. Recent developments in the world economy seem to indicate that the access to international capital flows will remain difficult for most poor countries in the immediate future. The concern is about a presumed decline in global savings availability, associated in particular with declining savings rates in the major economies (G-7) where the bulk of global financial resources is generated. A reduced supply of global savings must meet increased demands for investment resources in the 1990s. Capital demands are expected to remain high in the major economies themselves, while large new capital demands are being projected for the economic transformation in Eastern Europe and the republics of the former Soviet Union, for the reconstruction in the Middle East after the Gulf war and for action programmes to save the global environment. Funds available for the developing countries may be 'crowded out' by these new demands for global savings. Alternatively, since *ex-post* global savings and investment should balance, attempts to satisfy all these demands (including demands for increased capital flows to developing countries) will trigger a global adjustment process which is likely to lead to higher world interest rates affecting economic growth and trade in both rich and poor countries.

The purpose of this paper is to analyse the determinants of a possible growing 'savings shortage', its implications for the availability of financial resources for developing countries in the 1990s and the global macroeconomic interaction effects of increases in capital transfers to these countries. ***Section I*** assesses the main trends and determinants of the supply of global savings. It is suggested that falling trends are less secular than suggested in some studies. Nevertheless, there is little reason to expect a strong recovery of global savings in the 1990s; rather, structural factors indicate a falling tendency over the medium run. ***Section II*** reviews the magnitude and relevance of recent projections of the so-called 'new' capital demands. Many of the existing projections that appear in policy documents of Governments and international organizations are little more than back-of-the-envelop calculations based on crude assumptions. More elaborate studies at best apply a partial-equilibrium approach to estimate capital requirements of a particular group of countries. Taken together the 'new capital demands' are quite large indeed in relation to global macroeconomic aggregates. This calls for a global general-equilibrium framework to assess the implications if such demands are to be satisfied. Before entering into that question, however, the structural conditions of developing country access to international financial resources are assessed in ***section III***. Developing countries typically have restricted access to the global capital market. In the latter part of the 1980s some developing countries seem to have regained access to private capital markets, particularly larger flows of direct foreign investment and portfolio investment came their way. The analysis shows, however, that this development has been limited to a very small number of countries. The section also discusses the problem of the sizable foreign assets holdings of private agents from developing countries. It is suggested that a repatriation of this 'capital flight' money is likely to be heavily dependent on success in the adjustment effort leading to economic recovery and for which, in most countries, additional capital flows will be required first. Official finance is seen to remain the principle source of external funding on which most of the least developed countries (LDCs) will have to rely in the 1990s. Access to this source may become heavily constrained by fiscal problems in the donor countries and competing demands from Eastern Europe.

If funds from these sources would be forthcoming for developing countries, there will be important global repercussion effects, the cost of which may fall to a considerable extent on the LDCs. ***Section IV*** takes up the latter scenario and analyses the nature of the global adjustment effects. Since there is no single and broadly accepted global model framework, several existing world models are reviewed. First, trade effects are isolated using a simple linear world model and the outcomes are compared with those of other models emphasizing trade links. Next, several empirical global macroeconomic models and their respective simulation results of enhanced capital transfers to developing are compared. Although these models have some crucial differences in specification, they all hint at the critical role fiscal adjustment in the major economies is to play in the 1990s to ensure a more stable global economic environment for the developing countries. Otherwise, with inadequate fiscal adjustment, interest rate and financial instability are expected to produce worldwide recessionary effects, with the developing countries far worse off even with increased financial flows coming their way. ***Section V*** summarizes the main findings and policy conclusions, but also reiterates both the importance and the limitations of existing world models for policy use.

I. Trends and determinants of global savings

Is the concern about a reduced global savings supply leading to a savings shortage justified? This section tries to provide insight in some detail. First, world-wide trends in *ex-post* savings and investment demands are analysed. Subsequently (section IV.B), an assessment is given of the observed determinants of private and public savings and the likely prospects for the decade ahead.

A. Falling savings rates?

Is the decline in the global savings rate during the 1980s structural and likely to extend far into the 1990s? Figure 1, based on recent World Bank data,[1] shows that the world savings rate fell by about 2 percentage points between the early 1970s and the mid 1980s, i.e. from on average 21.8 per cent of world GNP in 1970-1973 to 19.9 per cent in 1983-1985 (see also table 1). However, in recent years there has been some recovery of world savings: 20.6 per cent of world GNP in 1986-1990. Thus, though it is well below the level of the 1960s and 1970s, the fall in the global savings rate may not be secular. Trends differ between the major countries and regions in the world and between economic agents. Figure 2 shows that, for the world economy as a whole, private savings have moved upwards, while goverment savings have fallen. This has led to a growing worldwide gap between, on the one hand, private savings surpluses and, on the other, public sector deficits. The observed trends relate to *ex-post* balances and as such they do not pose a problem in themselves. However, cumulative deficit and surplus savings positions sustained over long periods of time involve large shifts in liability and asset positions of governments and private sector agents, which in turn may affect their savings behaviour and financial market developments. These aspects will be discussed further below. First the diverging trends between countries and regions of the world economy will be described.

This analysis must start with some caveats about the data. Existing data contain substantial statistical discrepancies. This is most obvious in the global savings and investment estimates. Figures 1 and 4 show that the two global macroeconomic aggregates are not equal as they should be according to world accounting rules.[2] This discrepancy has been growing over the past two decades to a recorded global savings gap of about 0.4 - 0.5 per cent of world GNP. This compares,

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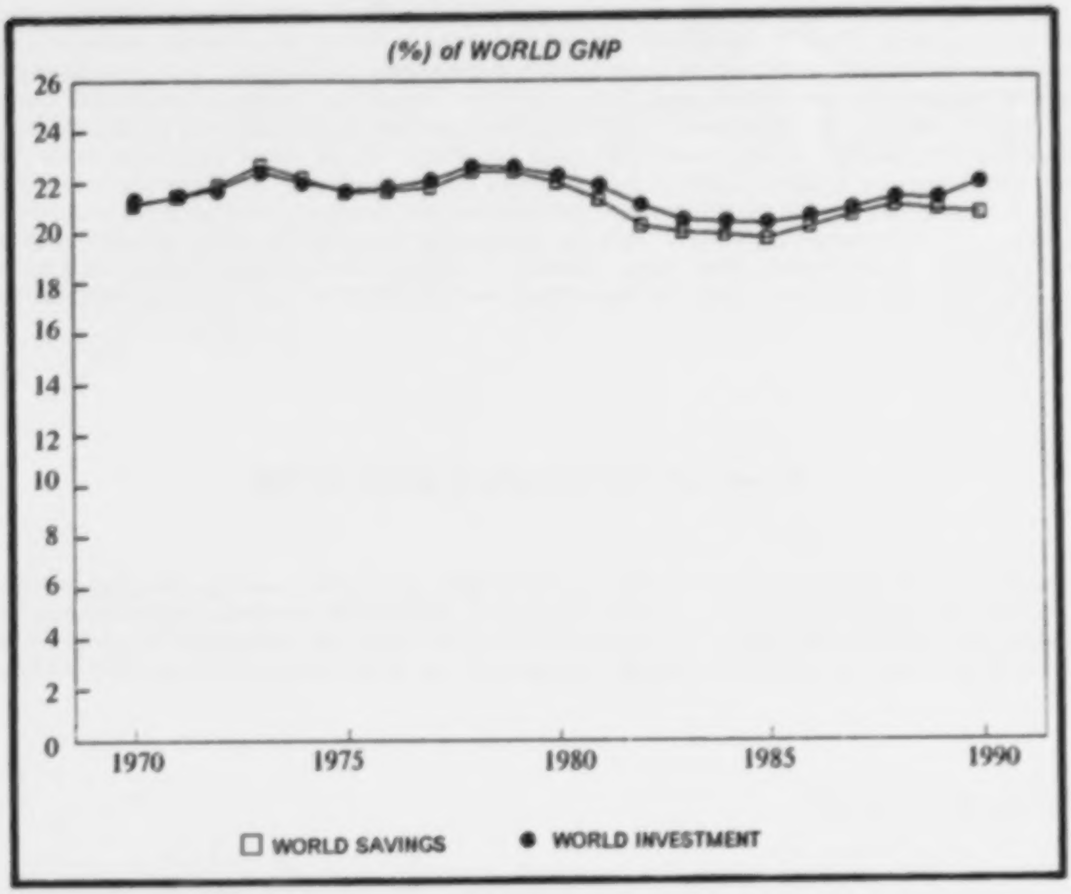
[1] Estimates are derived from World Tables (diskettes, November 1991 update) and the DEC Analytical Data Base (DAD) of the Bank's International Economics Department, which probably gives the best country coverage and provides consistency checks for national accounts, balance of payments, government finance and debtor reporting system data.

[2] See Vos (1989, 1991) for an extensive treatment of a consistent accounting system for a multi-country world economy.

Figure 1
GLOBAL SAVINGS AND INVESTMENT, 1970-1990



in definitional terms, to the world current account discrepancy.[3] Although the statistical error is small relative to global savings or global GNP, it is large compared to the numbers for the new capital demands and the numbers relevant for the global adjustment process discussed in this paper. During the 1980s the discrepancy was annually between US$50 and 100 billion which is in the order of magnitude of the estimates of the additional annual capital requirements for developing countries in the 1990s. The global discrepancy equals about 0.7 per cent of GNP of the industrialized countries, which is at the level of the DAC target for development assistance to developing countries and is double the size of actual aid flows. Consequently, the data presented in this paper should be taken with the necessary caution.

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[3] The following national and global accounting identities can be defined:

$$S_i - I_i = CAB_i$$

$$\sum_i^n CAB = \sum_i^n E_i - \sum_i^n M_i - \sum_i^n R_i = 0$$

$$\sum_i^n S_i - \sum_i^n I_i = 0$$

where it says that the savings-investment balance of country i ($S_i - I_i$) equals the current account balance (CAB_i), which is defined by exports less imports of goods and services ($E_i - M_i$) less net factor payments and current transfers to abroad (R_i). Exports of one country imply imports for another so that the sum of the CABs of all countries should add to zero. By implication also the *ex-post* world savings-investment balance should be equal to zero.
The data used in the graphs and the tables combine national accounts and balance of payments data. Gross domestic investment (private and public) and private gross national savings are based on national accounts data. The current account balance is based on balance of payments data. Gross national savings are derived as $S = CAB + GDI$ and government savings as $S_g = S - S_p$.

Table 1

GLOBAL SAVINGS AND INVESTMENT RATES, 1970-1990

(Percentage of GNP)

	1970-1973	*1974-1977*	*1978-1982*	*1983-1985*	*1986-1990*
High income countries					
GNS (S)	22.93	21.81	21.73	19.70	20.73
Private (S_p)	19.39	20.29	20.95	20.39	19.62
Public (S_g)	3.54	1.52	0.77	-0.68	1.11
GDI (I)	22.64	22.17	22.04	20.21	21.17
Private (I_p)	18.78	18.35	18.45	17.17	18.05
Public (I_g)	3.86	3.95	3.99	3.93	3.82
S-I	0.28	-0.37	-0.32	-0.51	-0.44
Private (S_p-I_p)	0.61	1.94	2.50	3.21	1.57
Public (S_g-I_g)	-0.32	-2.30	-2.82	-3.72	-2.01
Eastern Europe and former Soviet Union					
GNS (S)	20.15	19.75	19.07	20.26	17.04
Private (S_p)	3.48	2.89	3.57	3.93	7.70
Public (S_g)	16.68	16.86	15.50	16.33	9.33
GDI (I)	20.08	20.42	19.05	19.40	16.98
Private (I_p)	1.07	1.24	1.10	1.13	0.79
Public (I_g)	19.01	19.10	18.99	19.13	19.17
S-I	0.08	-0.67	0.02	0.86	0.06
Private (S_p-I_p)	2.41	1.64	2.47	2.80	6.92
Public (S_g-I_g)	-2.33	-2.31	-2.45	-1.94	-6.86
Major oil exporters					
GNS (S)	26.04	47.02	37.42	20.69	18.88
Private (S_p)	12.85	18.20	10.65	6.65	7.41
Public (S_g)	13.19	28.82	26.77	14.05	11.47
GDI (I)	17.80	22.14	25.02	22.65	17.99
Private (I_p)	5.19	6.73	9.50	8.13	5.26
Public (I_g)	12.61	12.12	12.96	14.24	15.41
S-I	8.24	24.88	12.40	-1.95	0.89
Private (S_p-I_p)	7.66	11.47	1.15	-1.48	2.15
Public (S_g-I_g)	0.58	13.41	11.25	-0.47	-1.27
LDCs					
GNS (S)	17.66	19.68	20.24	19.87	22.44
Private (S_p)	10.28	11.56	11.20	12.77	17.55
Public (S_g)	7.37	8.11	9.05	7.10	4.88
GDI (I)	18.95	21.84	23.49	21.12	23.04
Private (I_p)	8.87	10.55	10.96	9.59	12.22
Public (I_g)	10.08	10.08	10.45	10.86	11.29
S-I	-1.29	-2.16	-3.25	-1.25	-0.60
Private (S_p-I_p)	1.42	1.01	0.23	3.18	5.33
Public (S_g-I_g)	-2.71	-3.18	-3.48	-4.43	-5.93

For source and notes see end of table.

Table 1 (concluded)

GLOBAL SAVINGS AND INVESTMENT RATES, 1970-1990

(Percentage of GNP)

	1970-1973	*1974-1977*	*1978-1982*	*1983-1985*	*1986-1990*
World					
GNS (S)	21.77	21.86	21.70	19.91	20.60
Private (S_p)	15.51	16.54	17.12	17.06	18.01
Public (S_g)	6.26	5.27	4.57	2.81	2.65
GDI (I)	21.68	21.97	22.11	20.43	20.99
Private (I_p)	14.45	14.68	14.69	14.66	14.59
Public (I_g)	7.23	7.23	7.29	7.34	7.33
S-I [a]	0.09	-0.11	-0.41	-0.53	-0.39
Private (S_p-I_p)	1.06	1.95	2.04	2.99	2.56
Public (S_g-I_g)	-0.97	-2.06	-2.45	-3.52	-2.93

Source: World Bank data. Ratios derived from current US dollar values.

Note: GNS (S) = Gross National Savings (= Current Account Balance *plus* GDI). GDI (I) = Gross Domestic Investment. S-I = GNS - GDI = CAB. Subscripts p and g stand for private and public (general government) sectors respectively.

[a] The world savings-investment balance, and hence the world current account balance, should in principle be equal to *zero*. The non-zero entries thus represent the consolidated statistical global accounting discrepancy. See text and e.g. IMF (1987), Vos (1989), Luttik (1992), and De Jong, Vos and Jellema (1991) for futher discussion.

The causes of the discrepancy have been discussed elsewhere and these will not be detailed here.[4] Within the present context it is relevant to have some idea how the discrepancy affects the savings-investment balances across countries. Given the complex structure of the discrepancy when observed transaction-by-transaction, no definite and clear-cut conclusions have been drawn so far. Probably the most complete study on this topic (Luttik 1992) suggests that, on balance, the current accounts of the major economies are only slightly affected and that a major part of the discrepancy should be allocated to major oil exporters in the Middle East. The latter implies that, particularly during the early 1980s, savings surpluses of this region were under-estimated. If so, there has been a corresponding under-recording of foreign assets of this region which could counterbalance the apparent overstatement of the external asset position of some of the main industrialized countries.

Having said this, let's now turn to the major trends in global savings and investment patterns over the past two decades. The main features can be summarized as follows:

(a) About 80 per cent of global savings is generated in the industrialized countries and nearly two-thirds in the G-7 countries (figure 5). Economic growth and savings decisions in these countries thus have an overwhelming influence on the supply of world investment finance resources.

(b) Global savings-investment balances have shown major shifts over the past two decades (see figure 4): (a) the major industrialized economies (G-7) traditionally have been net creditors to the rest of the world (LDCs and the rest of the OECD); (b) after the first oil price hike, G-7 surpluses dwindled and savings surpluses of major oil exporters (around 0.5 per cent of world GNP) became (directly or indirectly) the major source to finance deficits elsewhere, particularly in the LDCs; (c) oil-exporter surpluses vanished in the 1980s,[5] while the G-7 countries became net debtors in the

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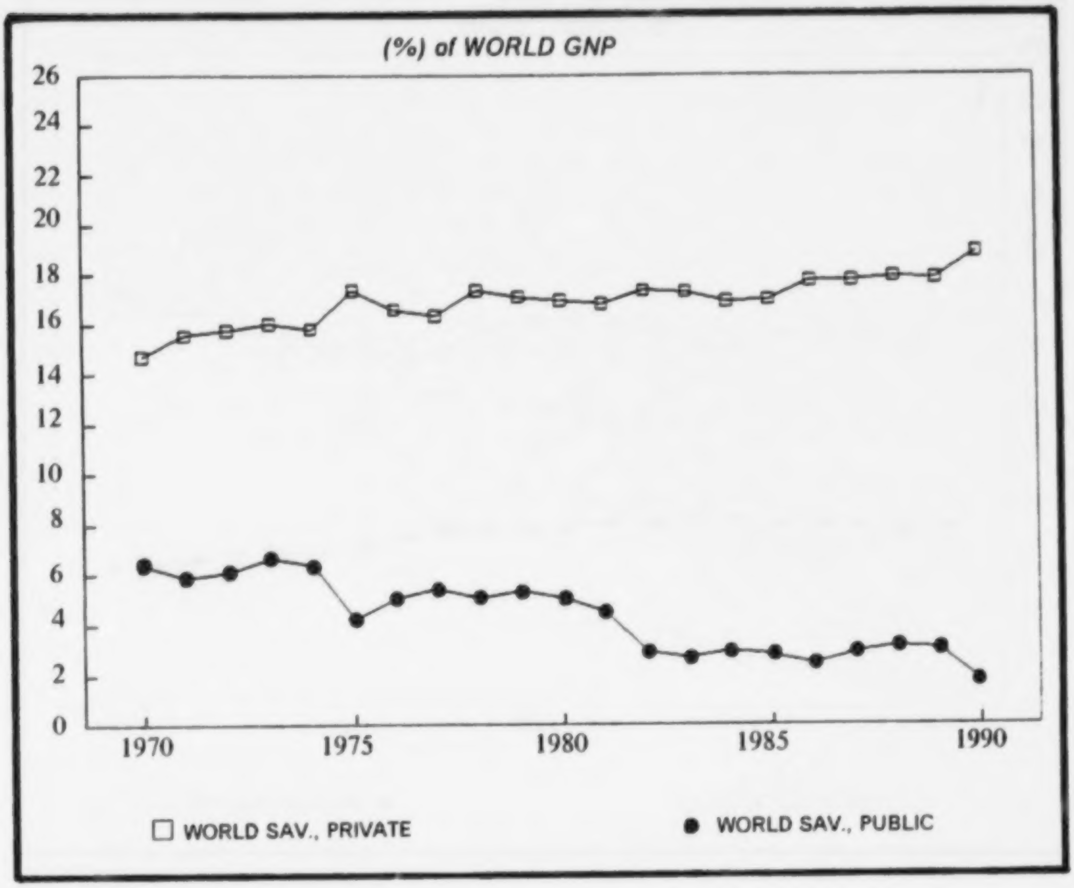
[4] See IMF (1987), Vos (1989), De Jong, Vos and Jellema (1991), Luttik (1992) and IMF (1992).

[5] This trend should be taken with a wide margin of error, given problems of coverage of some major oil exporters in the 1980s (e.g. Iran and Iraq after entering in a war in 1980 are no longer covered). See also the remarks made earlier about the widening global accounting discrepancy.

Figure 2
GLOBAL SAVINGS, PRIVATE AND PUBLIC, 1970-1990



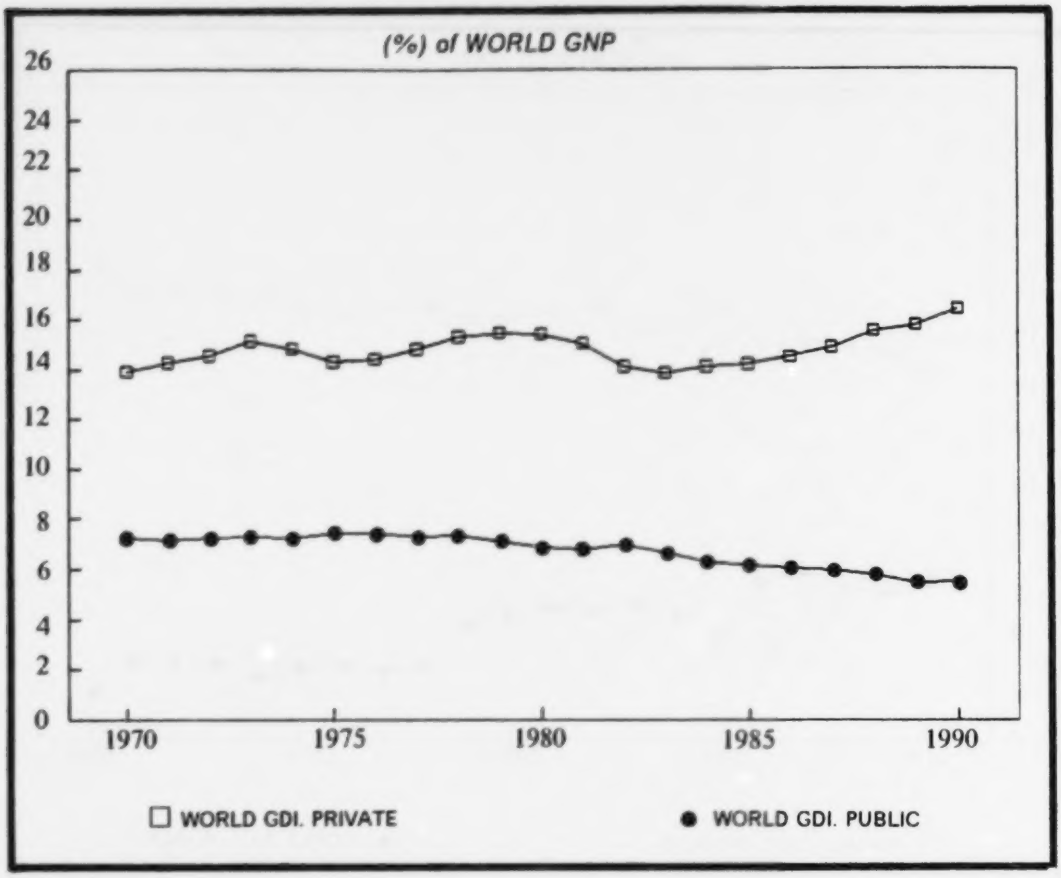
aggregate; as a consequence, reduced international finance availability forced LDCs to reduce their current account deficits; and (d) the former socialist economies in Eastern Europe (EE6 + SU) have remained throughout the past two decades at nearly balanced savings-investment positions.

This picture is still far too aggregate, however. The savings-investment balance positions conceal much larger imbalances observed particularly in the G-3 countries (United States, Japan, Germany), but also conceal differences in the satisfied demands for global savings between groups of LDCs.

(a) The global macroeconomic significance of the diverging pattern of savings-investment balances in the 1980s between the three major economies is pictured in figure 7. Germany and Japan produced joint savings surpluses of between 0.5 and 1.0 per cent of world GNP, which could largely, though not entirely, finance large United States deficits. Figure 8 indicates that for the G-3 as a group, large private savings surpluses were required of around 1.0 and 1.5 per cent of world GNP.

(b) The *ex-post* claims of developing countries on global savings are relatively small, when expressed in terms of total savings or world GNP. Figures 9 and 10 suggest that the net use of global savings by LDCs averaged around 0.3 per cent of world GNP over the past two decades. It peaked at 0.7 per cent at the height of the private lending boom around 1980-1982 just before the outbreak of the debt crisis. Latin American and East Asian middle-income countries took the major share. The closure of private capital markets for LDCs after the debt crisis is clearly expressed in reduced savings-investment imbalances. Their use of external savings was less than

Figure 3
GLOBAL INVESTMENT, PRIVATE AND PUBLIC, 1970-1990



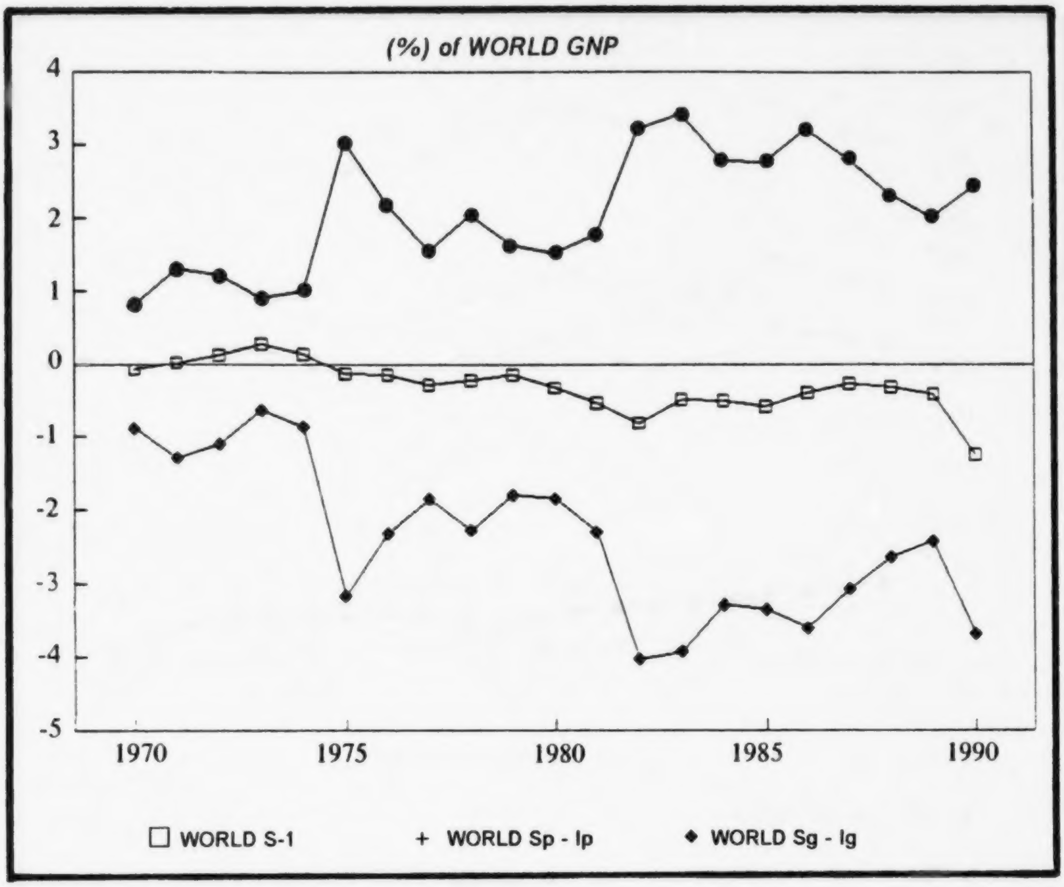
0.2 per cent of world GNP in 1986-1990. The East Asian countries even moved to a surplus position (figure 10). This Asian contribution to available global resources has not been very big in global economic terms, however; between 1986-1990 this surplus was less than 0.1 per cent of world GNP.

Underlying these widening global imbalances are falling private savings rates in some of the major economies, particularly the United States, and falling private investment rates, particularly in Japan and Germany. For LDCs, access to external finance seems to determine much of the shift in private and public savings-investment balances.

(a) The concern over a global savings shortage stems to a large extent from a dramatic decline in the United States savings rate in the 1980s: it fell from 18.7 per cent of United States GNP in 1978-1982 to 14.1 per cent in 1986-90 (see annex tables A1.1a-c). This decline reflects a steep fall in both private and public savings rates. Savings rates have also tended to fall in Japan and Germany since 1970. Since the mid-1980s, however, savings rates improved in both countries. In Germany both private and public savings rates have tended to increase since 1983. In Japan private savings rates have continued to fall, but there was a recovery of the overall savings rate in 1986-1990 due to fiscal adjustment and subsequent increase in the public savings rate.

(b) The steepest fall in national savings rates may be observed in the major oil exporting countries (MOEs), which - leaving statistical problems aside - is associated with rising private and government consumption, foreign workers' remittances to abroad

Figure 4
GLOBAL SAVINGS-INVESTMENT BALANCES, PRIVATE AND PUBLIC 1970-1990

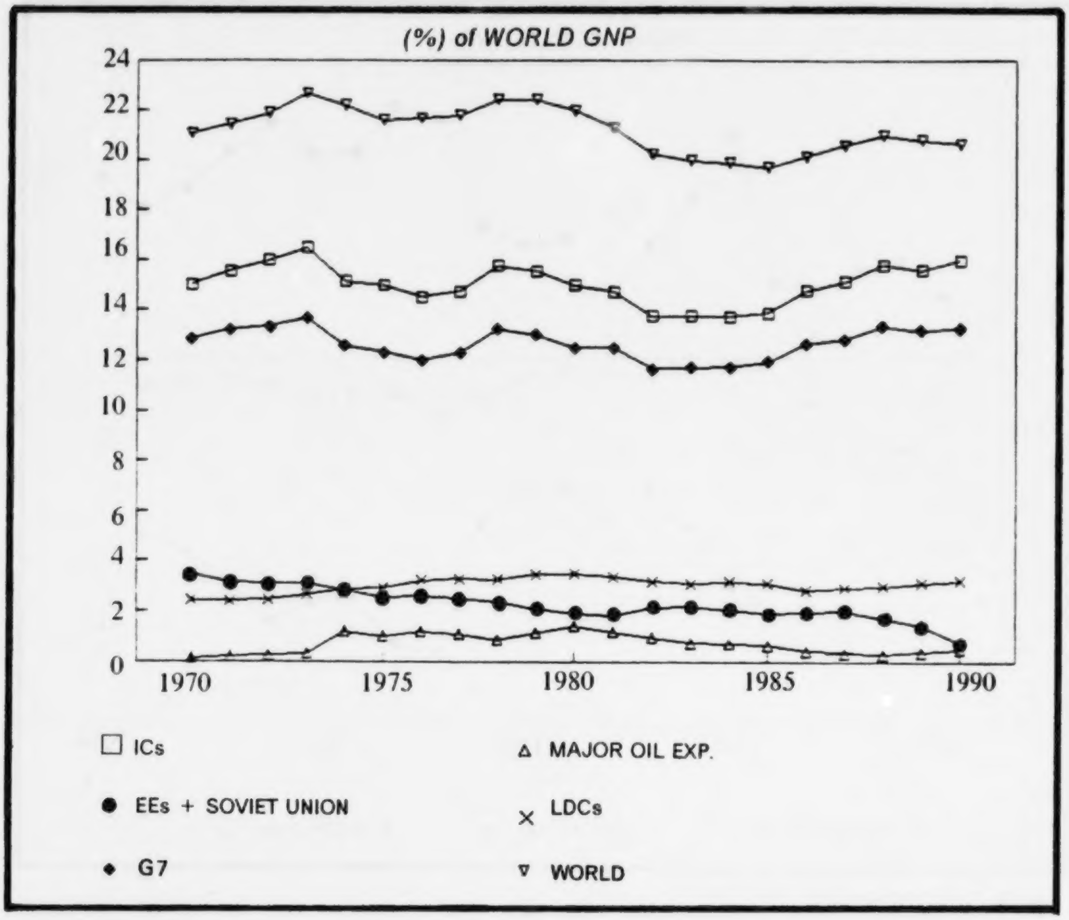


Source: World Bank data.

and armaments expenditures. These factors appear more important in explaining falling savings surpluses of MOEs than rising domestic investment. In fact, the investment rate of these countries fell in the 1980s.

(c) Contrary to IMF data (Aghevli *et al.* 1990), no falling savings rate for developing countries has been observed. Aggregate LDC savings remained stable at around 3.5 per cent of world GNP throughout the 1970s and 1980s (figure 5). As a share of LDCs' own GNP, national savings increased during the 1970s, fell in the years of economic stabilization immediately following the debt crisis (1983-1985), but increased again in recent years (1986-1990) (see table 1 and annex table A1.1a-c). This may have to do with the fact that many LDCs went through a series of structural adjustment programmes. However, income growth remains the main determinant of private savings in developing countries (see Schmidt-Hebbel and Webb 1992), while the degree of success of structural adjustment programmes to raise growth rates has been, to put it mildly, rather diverse across countries (Mosley, Harrigan and Toye 1991). Thus the policy influence on the observed trends is not immediately clear. Countries in sub-Saharan Africa (SSA) and Latin America (LAC) have lower savings rates (respectively about 11 and 19 per cent of GNP) than in the early 1970s or even before, despite some recovery in 1986-1990 (annex tables A1.1a-c). In SSA, falling per capita incomes and steeply falling external terms of trade probably underlay the collapse of the private savings rate in 1978-1985. Some improvement in these indicators in 1986 to 1990 led to a recovery in the private savings rate. In contrast, in LAC, private savings appear to have increased even during the crisis years of the 1980s. Much of this relates to 'forced' savings induced

Figure 5
GLOBAL SAVINGS RATES, 1970-1990

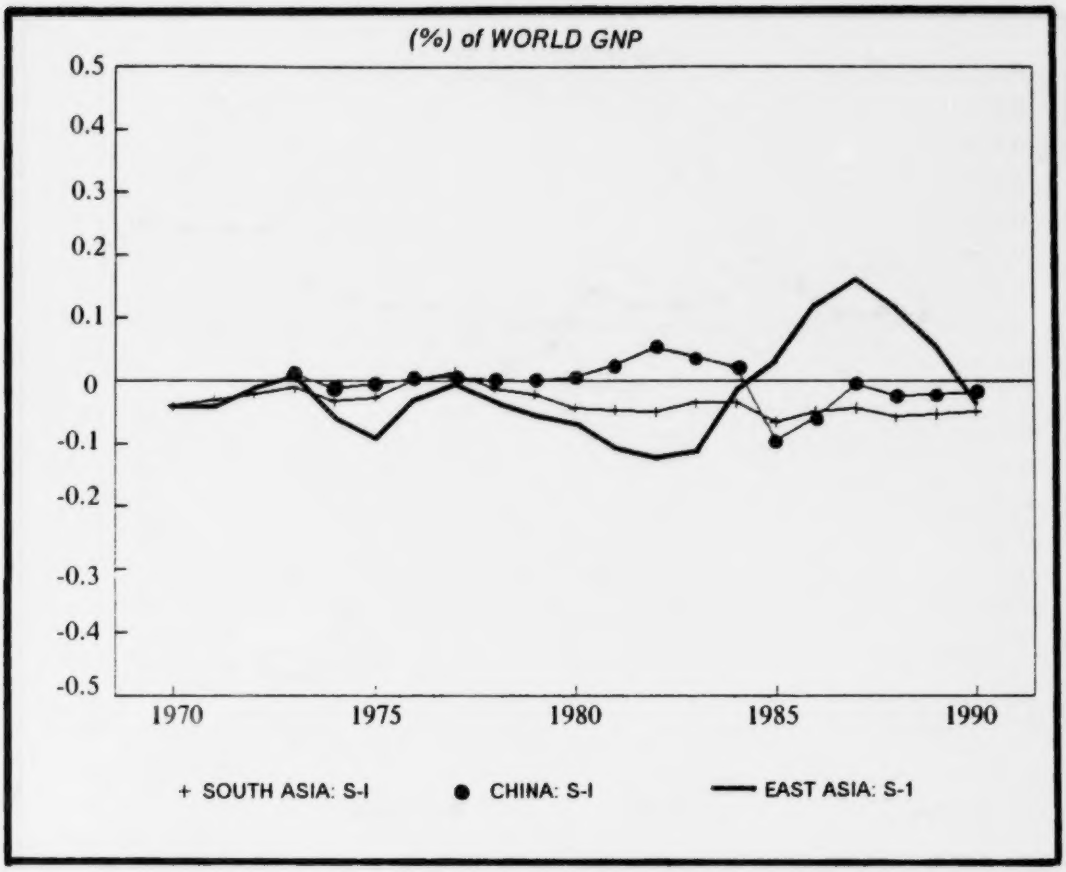


by the high inflation rates in most of these countries. High inflation has been associated with steeply falling public savings rates and rising fiscal deficits. Falling public savings figure in the rising external debt service burden of the public sector of these countries. With (much more) limited access to foreign finance than in the previous decade, falling savings rates led to falling gross investment rates in SSA and LAC in the 1980s. In SSA GDI fell to 12 per cent of GNP in 1983-1985 and recovered to 15 per cent in 1986-1990: still below the 1970 level and probably just about enough to replace the existing capital stock, but not enough to expand production capacity in any significant way. Also in LAC the investment rate fell steeply in 1983-1985: from 23 to 17 per cent on average (in some countries the drop was much steeper). The rate moved back to 20 per cent in 1986-1990, reflecting substantial recovery in some countries (Mexico, Brazil, Chile), while others still lagged behind.

(d) More stable and upward savings trends can be observed in South and East Asia. Most countries in these regions followed more prudent fiscal policies, keeping public savings rates up. External indebtedness either did not take quite the dimensions it took in SSA and LAC (the Philippines being a noticable exception) or could be coped with having dynamic export-oriented industries already in place. In many parts of Asia high growth rates could be sustained, stimulating higher private savings rates.

In sum, falling savings rates were not a universal trend. The central problem would appear to lie in the decline of private savings in the major economies (particularly the United States and Japan). Adequate fiscal adjustment could help to compensate for this through rising public savings and thereby ease pressures on capital markets. Particularly in the United

Figure 6
LDC EX-POST DEMAND FOR GLOBAL SAVINGS, 1970-1990
SOUTH ASIA, CHINA AND EAST ASIA & PACIFIC



States this has been insufficient and the national savings rates has continued to fall. Japan and Germany managed to increase their national savings rates towards the end of the 1980s. Should this provide a basis for optimism over the adequacy of global savings in the 1990s?

B. Determinants of global savings supplies and prospects for the 1990s

The evidence available concerning the structural determinants of savings in the major economies does not give rise to a great deal of optimism. Private savings in these countries are expected to show further downward trends.[6]

(a) Demographic factors, in particular an increased elderly-dependency ratio, are perceived as forming a key determinant behind falling private savings rates. Some studies have down-played the importance of demographic change as a major determinant of falling private savings in the United States, Japan and the European Community in the 1980s (Bosworth *et al.* 1991; *European Economy* 1990), but with regards to the long run there seems to be a broad consensus on potentially large declines in private savings owing to the expected significant rise in the 64age cohort in total population. This is expected to become an important factor in Japan and Europe in the 1990s and in North America by the turn of the century.

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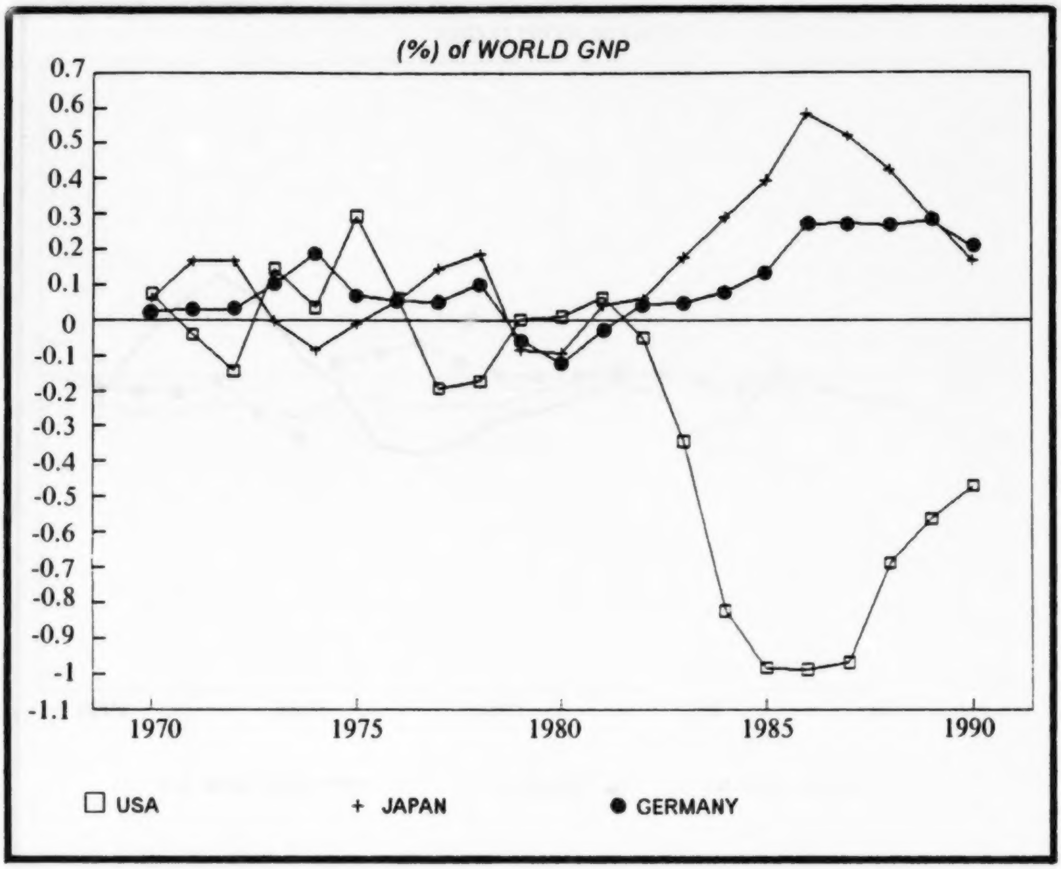
[6] See among others, Aghevli *et al.* (1990), Bovenberg and Evans (1991), *European Economy* (1990), Masson (1990).

Figure 7

G-3 SAVINGS-INVESTMENT BALANCES, 1970-1990
USA, JAPAN, GERMANY



(b) Rising private wealth is seen as another determinant of falling private savings rates in the 1980s. The value of equities and housing increased significantly and this would diminish the need for saving out of current income. One study suggests this might explain about three-quarters of the decline in the savings rate in Japan and a 2 percentage point decline in the savings rate in the United States (Aghevli *et al.* 1990). The role of the interest rate is theoretically ambiguous. A higher interest rate increases future private income and wealth, inducing an increase in current consumption. It may also encourage current savings as future consumption will be expected to increase. While the empirical evidence is not conclusive, it does seem that interest rate changes have had only a slight effect on savings in the major economies (Aghevli, *et al.* 1990). To the extent that household savings respond positively to a rise in interest rates, this may be (partly) offset by falling corporate savings.[7] Higher interest rates have a negative impact on corporate savings. Thus the effects of wealth holdings and interest rates on private savings in the major industrialized countries seem ambiguous. This suggests a rather low elasticity of private savings to the interest rate, so that an *ex-ante* global savings shortage will not allow for a quick capital market adjustment. Many empirical models of the world economy, in contrast, assume a fairly elastic response of private savings to interest rate changes and therefore, as discussed in section IV, such expectations may be too optimistic regarding the speed of the global adjustment process.

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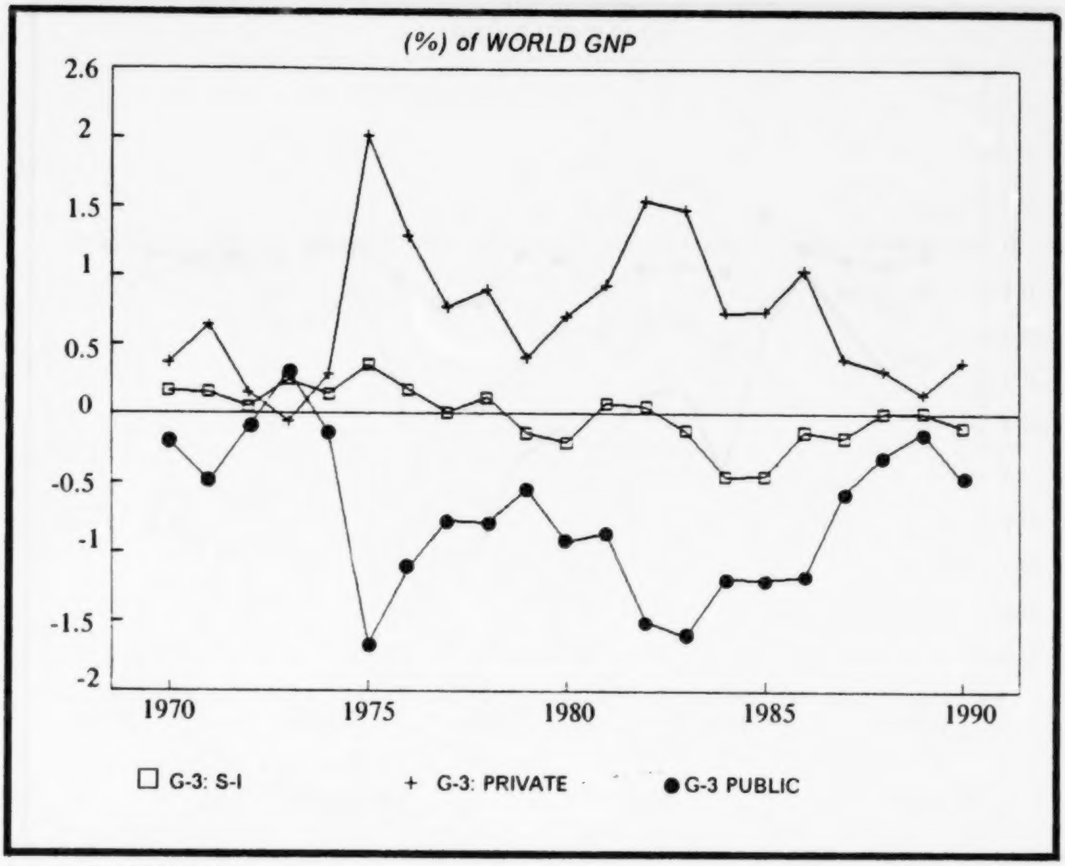
[7] Household savings and corporate savings tend to show opposite trends in OECD countries (see *European Economy* 1990), though not in a one-to-one relationship. As said higher interest rates may have some positive effect on household savings, but raise costs and thus reduce profits of companies. Also, higher corporate savings may have a positive effect on asset prices, which will raise household wealth and affect household savings negatively.

Figure 8

G-3 SAVINGS-INVESTMENT BALANCES, 1970-1990
– PRIVATE AND PUBLIC –



Source: World Bank data.

(c) Fiscal deficits may have a positive impact on private savings, according to some theoretical notions. First, fiscal expansion may lead to higher income growth under unemployment and induce higher private savings. Secondly, a higher public debt may lead private agents to save more in order to compensate for an expected tax increase in the future.[8] Empirical evidence shows, however, a weak offsetting tendency between public deficits and private savings; the trends in the relevant ratios for the United States being the clearest example: the United States fiscal deficit widened from 1 per cent of GNP to 3.3 per cent between 1978-1982 and 1983-1985, while private savings fell from 18.2 to 17.2 per cent.

(d) Widening fiscal imbalances and accumulation of public sector liabilities further undermine the responsiveness of national savings to global interest rate shifts. Interest rate increases in response to an *ex-ante* savings gap will push up public debt service obligations and so depress government savings. Table 2 shows some approximate figures of the shifts in the net (financial) asset positions of the three major economies. The G-3 shifted from a net creditor to a net debtor position vis-à-vis the rest of the world between 1980 and 1989 (the creditor positions of Japan and Germany do not compensate for United States net liabilities), but more salient is the growth of public liabilities in all three economies. These asset positions are

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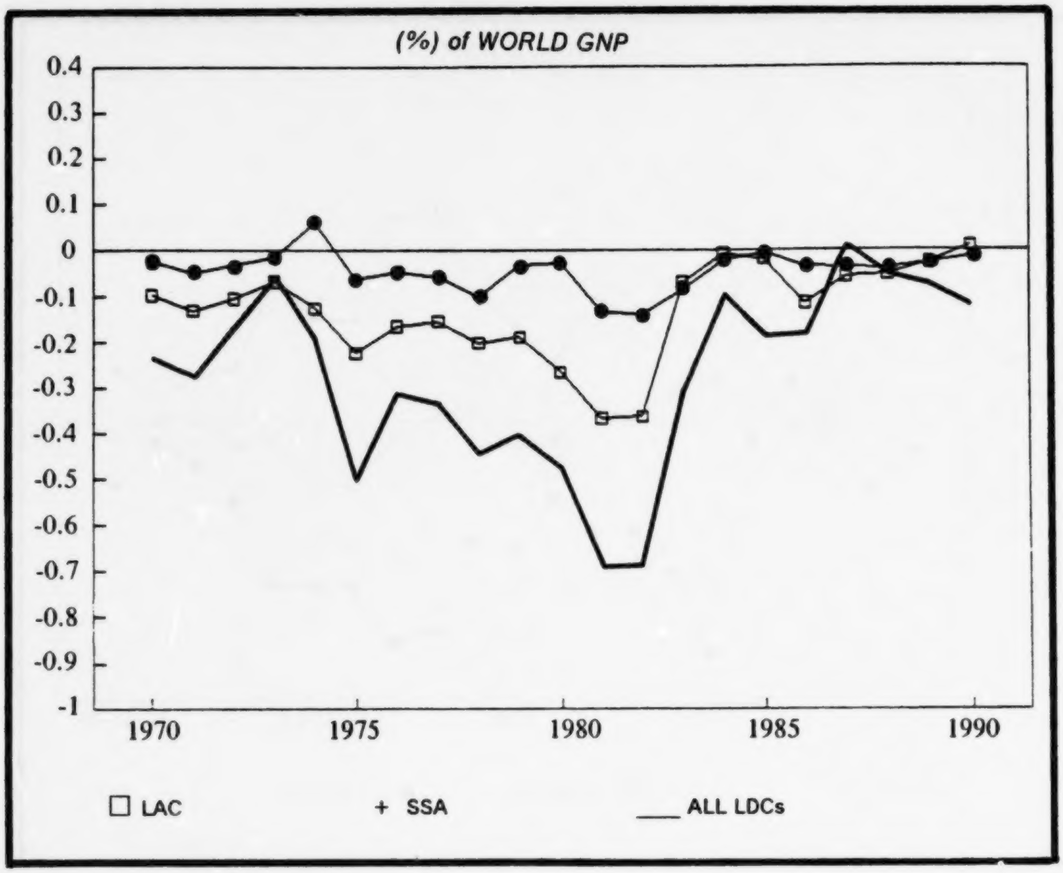
[8] This intertemporal private savings behaviour in response to fiscal deficits and public sector borrowing is known as the 'debt-neutrality' or Ricardo-Barro equivalence hypothesis.

Figure 9

LDC EX-POST DEMAND FOR GLOBAL SAVINGS, 1970-1990
-- ALL LDCs, LATIN AMERICA AND SUB-SAHARA AFRICA --



likely to hamper a smooth adjustment process in the 1990s and, without major fiscal adjustment, will keep public savings down in the major economies and thereby weigh on global savings.

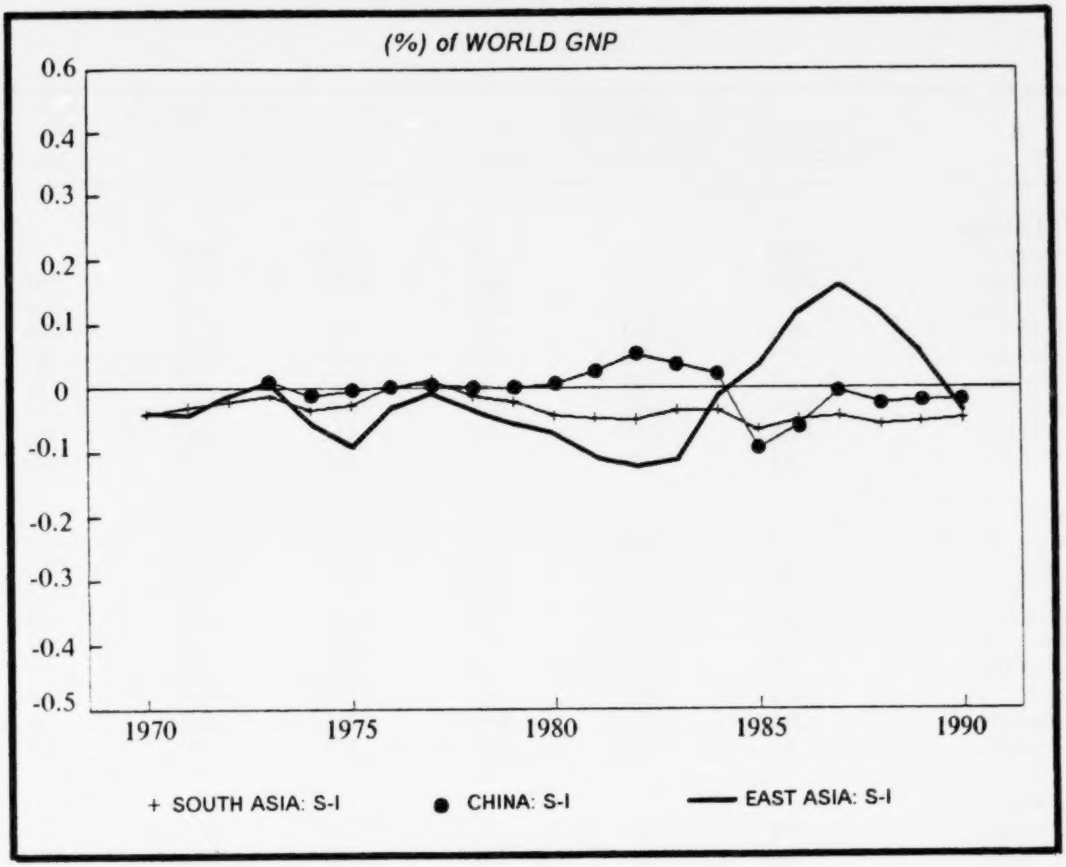
In sum, despite some recovery in the supply of global savings towards the end of the 1980s, the factors listed above suggest that there is not much reason for optimism in terms of the trend continuing during the 1990s. Private savings are expected to stagnate in the major economies as are public savings unless significant fiscal adjustment takes place. New capital demands from the East and the South may thus encounter a serious savings supply constraint in the North.

II. Additional demands for global savings

Before entering into the discussion of the global effects of increased capital transfers to the East and, particularly, to the South under the world economic conditions sketched above, it may be useful to identify the orders of magnitude of the new capital demands as they have been put forward in various studies and policy documents. It is not the objective of this paper to improve on any of the existing estimates of new demands for global savings. The numbers produced all tend to have global macroeconomic significance; some would require, if satisfied, revolutionary changes in the existing global savings and investment pattern. It does seem

Figure 10

LDC EX-POST DEMAND FOR GLOBAL SAVINGS, 1970-1990
-- SOUTH ASIA, CHINA AND EAST ASIA & PACIFIC --



Source: World Bank data.

useful, however, to assess their meaning, before entering into the discussion of possible global economic repercussions. The numbers appear as follows:

(a) Investment demand in the major industrialized countries should remain high according to some calculations (IMF 1991b) in order to achieve more satisfactory growth rates in the 1990s. The following sections show how growth rates in the North are also crucial for economic performance in the South and East. In order to maintain the growth rate of output at 2.75 per cent per annum, like the 1980s, the industrialized countries will have to raise their average investment rate by 1 percentage point during the period 1991-1996 (IMF 1991b: 45). With an expected fall in the private savings rate of 0.75 percentage points, savings may fall short. If Governments of the industrialized countries meet their intended budget targets, however, this is expected to lead to reduced absorption of savings by Governments of 2 percentage points of GNP. Full implementation of these targets thus seems a minimum requirement to provide the investment finance required to sustain growth in the North.

(b) Wide-ranging estimates exist as to the external finance requirements for the transformation of the Eastern European countries, the Community of Independent States (CIS, i.e. the former Soviet Union) and for German unification. All are, however, sizeable and of global macroeconomic importance. Table 3 summarizes the range of estimates derived from a number of studies (see annex table A1.2 for details).[9]

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[9] Collins and Rodrik (1991), IMF (1991b), Papadia *et al.* (1991), Masson and Meredith (1991).

Table 2

G-3: SHIFTS IN NET FINANCIAL ASSETS POSITIONS, PRIVATE AND PUBLIC SECTOR, 1980 AND 1989

(Billions of US$)

	1980			*1989*		
	Assets	*Liabilities*	*Net*	*Assets*	*Liabilities*	*Net*
United States						
Domestic	1966	1966	0	4625	4625	0
Private	1966	1745	221	4625	3783	842
Public		221	-221		842	-842
Foreign	608	501	107	1412	2078	-666
Private	517	339	178	1253	1641	-388
Public	91	162	-71	159	437	-278
Total	2574	2467	107	6037	6703	-666
Private	2483	2084	399	5878	5424	454
Public	91	383	-292	159	1279	-1120
Japan						
Domestic	1169	1169	0	4040	4040	0
Private	1169	895	274	4040	3480	559
Public		274	-274		559	-559
Foreign	204	291	-87	1771	1477	294
Private	113	129	-16	1597	1410	187
Public	91	162	-71	174	67	107
Total	1373	1460	-87	5811	5516	294
Private	1282	1024	258	5636	4890	746
Public	91	436	-345	174	626	-452
Germany						
Domestic	744	744	0	1315	1315	0
Private	744	636	108	1315	1039	276
Public		108	-108		276	-276
Foreign	260	215	45	695	474	221
Private	190	185	5	581	349	232
Public	70	30	40	114	125	-11
Total	1004	959	45	2010	1789	221
Private	934	821	113	1896	1389	508
Public	70	138	-68	114	401	-287
Total G-3						
Domestic	3879	3879	0	9980	9980	0
Private	3879	3276	603	9980	8303	1677
Public	0	603	-603	0	1677	-1677
Foreign	1072	1007	65	3878	4029	-150
Private	820	653	167	3431	3400	31
Public	252	354	-102	447	629	-181
Total	4951	4886	65	13858	14008	-150
Private	4699	3929	770	13411	11703	1708
Public	252	957	-705	447	2306	-1858

Source: IMF, *Balance of Payments Statistics*, various issues (stock data). IMF, *International Financial Statistics*, various issues.

Note: Domestic asset positions refer to financial assets and liabilities only, net of inter-bank and intra-government positions.

Table 3

ALTERNATIVE ESTIMATES OF EXTERNAL FINANCING REQUIREMENTS OF LDCs, EASTERN EUROPE AND CIS IN THE 1990s

(Annual flows in billions of US$ of 1990)

	Net transfer [a] 1990		*Net resource flow [b] 1990*	*Financial requirements 1990s*	
	Total	*(Excl. grants)*	*Total*	*Low*	*High*
Developing countries					
All LDCs	16	(-10)	83	77	180
Sub-Saharan Africa	12	(1)	17	15	28
Asia	12	(7)	34	18	23
South Asia	4	(1)	8		
East Asia and Pacific	8	(6)	26		
Europe, Middle East and North Africa	-2	(-10)	13	8	8
Latin America and Caribbean	-6	(-9)	19	36	61
Eastern Europe and CIS					
EE5, CIS, German unification				55	393
Eastern Europe (EE5)			3 [c]	10	124
CIS			2 [c]	15	189
German unification				30	80
Total LDCs and Eastern Europe, CIS and GU				98	573
(As per cent of world GNP, 1990)				(0.7)	(2.7)

Memorandum: Net transfers by source

	Net transfers [a] 1990		
	Official (excl. grants)	*Grants*	*Private*
All LDCs	4	26	-15
Sub-Saharan Africa	2	11	-1
Asia	5	5	2
South Asia	3	3	-2
East Asia and Pacific	2	2	4
Europe, Middle East and North America	-4	8	-6
Latin America and Caribbean	1	2	-9

Source: World Bank, *World Debt Tables, 1991-92*, for net transfer and resource flow data to LDCs and annex table A1.2 for alternative estimates of financing requirements for the 1990s.

a Net disbursements of medium and long-term debt plus official grants plus net direct foreign investment less interest payments less profit remittances.

b Net disbursements of medium and long-term debt plus official grants plus net direct foreign investment.

c Data for EE5 and CIS refer to 1989 and new gross disbursements of medium and long-term publicized bank credits or bond issues taken from OECD (*Financial Market Trends*, 1991, table 12).

The upper bound estimates of required annual capital inflows shown are close to 2 per cent of world GNP but still quite modest compared to some other "needs" calculations.[10] The upper bound estimates take Collins and Rodrik's (1991) calculations of investment requirements based on a 7 per cent growth target of real GNP. The authors assume without explicit argument that all financial requirements (US$915 billion per annum, see annex table A1.2) have to be satisfied by external resources. These estimates of Collins and Rodrik have been adjusted in table 3, deducting projected national savings in Eastern Europe and CIS, assuming (possibly optimistically) a constant 1990 savings rate. The lower bound estimates for the EE5 and republics of the former Soviet Union have little to do with an estimate of recipients "needs", as these are based on a Marshall Plan-like operation. The estimates represent real per capita aid flows for Eastern Europe equal to that received by the western European countries after World War II (Economic Commission for Europe, 1990; Collins and Rodrik 1991).

(c) Capital-requirements estimates for developing countries are based on traditional methodologies originating from Rosenstein-Rodan's one-gap (savings gap) Harrod-Domar growth model (Rosenstein-Rodan 1961) and Chenery and Bruno's two-gap (savings and trade gap) model (Chenery and Bruno 1962). Despite the rigidity and obvious limitations of these model frameworks, they have remained influential to date. In essence, the approach is to set a desired level of GDP growth which, for a given capital-output ratio, determines the appropriate investment level. For a given savings rate and import coefficient, a domestic savings and a foreign exchange gap can be derived which will determine the financing requirements. Recent extensions of this framework (Bacha 1990, Taylor 1990) include a third gap, i.e. the fiscal gap, to take into account the "double transfer" problem that has plagued developing countries in the 1980s and 1990s: first, they have to send hard currency abroad to meet interest obligations, hence they need a trade surplus as net capital inflows are less than interest payments; and, second, the public sector is largely responsible for these payments, meaning it must run a non-interest budget surplus or find domestic finance. The three-gap model takes account of the fact that developing countries may face a binding 'financial' constraint as opposed to the 'real' external constraint emphasized by the two-gap model. Table 3 also summarizes a number of calculations of external financing requirements of developing countries based on two- gap (Fishlow 1987, Development Committee 1988), three-gap (WIDER, Taylor 1990) and current-account models[11] and applying modest growth targets. The range of estimates for annual external financial requirements for the 1990s lies between US$77 and 120 billion, which is somewhere between 0.5 and 0.8 per cent of GNP of the industrialized countries, or roughly the DAC target for development assistance. Do these imply additional demands for global savings? Table 3 also gives for comparison the net transfer[12] and net resource flow[13] to developing countries in 1990. The lower bound financial requirements would be covered by the net financial resource flow (including direct foreign investment) in 1990 which amounted to US$83 billion. However, it is more appropriate to look at the net transfer as the financing requirement estimates essentially refer to the trade gap (two-gap) or financing gap of required capital inflows less interest payments (three-gap).[14] Net transfers to developing countries were US$16 billion in 1990 (up from an average *negative* annual net transfer of US$5 billion in 1985-1989). Thus from the existing situation in 1990, net transfers to developing countries would have to increase by about US$60 to 100 billion during the 1990s to meet growth targets which are in the order of magnitude of 1.5 to 2.0 per cent per capita income growth. The gap is largest for the Latin American countries which, according to these estimates, would have to revert from a negative transfer of US$6 billion to a positive one of between US$36 and 60 billion. For sub-Saharan Africa there would be an additional demand of between US$3 and 16 billion per year, while in Asia additional demands are likely to be small.

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[10] Collins and Rodrik (1991) for instance also produce a capital requirements estimate of approximately US$1.6 *trillion* per year, which would be about 8 per cent of global GNP and almost equal that of the recipient countries. This estimate is based on simple production function (Cobb-Douglas type) calculations with fixed coefficients targetting to reach the capital-labour ratio of the industrialized countries in a time frame of 10 years. The resulting numbers may have an illustrative meaning, but that is as far as it goes.

[11] The World Bank study on African financing needs (World Bank 1991) uses a simple current account projections model with assumptions about export growth, import elasticities, projected debt service obligations and debt relief.

[12] Net transfer = net disbursements of medium and long-term debt + official grants + net direct foreign investment - interest payments on external debt - proof remittances.

[13] Net resource flow = net disbursements of medium and long-term debt + official grants + net direct foreign investment.

[14] An exception is the World Bank estimate of financing requirements for sub-Saharan Africa which is based on current account projections: the annual financial resource flow requirement is estimated at US$28 billion, while the capital inflow in 1990 amounted to US$17 billion.

(d) On top of the above-listed demands for global savings come demands for the reconstruction of the Middle East after the Gulf war and finance required to fund the global environmental action programme discussed at the United Nations Conference on Environment and Development (UNCED). The IMF has estimated additional external capital requirements for reconstruction in the Middle East at roughly US$13 billion per year for 1991-1996. Financing requirements for environmental action have also yielded a wide range of estimates. Agenda 21 of UNCED comprises an international action programme for the environment and development (on top of domestic efforts) with an estimated cost of US$125 billion per annum in the form of concessional assistance for the developing countries.[15] However, it is at the same time suggested that US$15 billion would be a 'more realistic' amount, given the absorptive capacity of countries to implement environmental programmes and given likely available finance for such purposes.

The sum of all these demands amounts to very impressive numbers indeed. Combining all the lower bound estimates would yield additional capital demands equivalent of 1.4 per cent of world GNP (about US$280 billion annually), while the upper bound estimates come to 3.8 per cent of world GNP (US$800 billion).[16] These numbers seem far too large for comfort. The previous section already sketched a rather pessimistic outlook for the growth in global savings and showed the rather narrow margins within which savings-investment balances (as a share of global GNP) of the major economies moved and which were enough to provoke substantial global adjustment effects. To satisfy their own investment demands and those in the East and the South, the developed economies will have to reverse trends in private and public savings rates.

Of course, the estimates of financing 'needs' in the 1990s discussed above are crude and calculated using rather simple methods. Some of the estimates, like the lower bound numbers for Eastern Europe and UNCED, do not reflect a calculation of financing requirements, but rather reflect "guesstimates" of the authors of what would be a 'realistic' level of capital flows. The models used to estimate 'needs' are based on very crude assumptions about economic behaviour, such as assuming constant savings rates and capital-output ratios over long periods of projection. Further, the methods are static and partial in the sense that domestic and global general equilibrium effects are not accounted for, e.g. in terms of the effects of

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[15] See UNCED (A/CONF.151/PC/100/Add.9) and the Tokyo declaration of the Eminent Person's Meeting on Financing Global Environment and Development (UNCED press release, 17 April 1992). It should be noted that Agenda 21 covers environmental *and* development programmes, such that there is likely to be some overlap with the estimates of financial requirements for developing countries discussed above. In fact, at UNCED (June 1992) it was agreed that the industrialized countries would try to raise aid flows to 0.7 per cent of GNP by the year 2005. This refreshed commitment to the old DAC target was, once again, non-binding.
The *World Development Report* (World Bank 1992) estimates a cost of US$75 billion of a set of environmental projects for developing countries. It is suggested, however, that not all of these additional investment costs should be covered by external finance, but rather that most could be funded by the LDCs themselves, i.e. out of income growth resulting from better economic management.

[16] These magnitudes are derived as follows:

	Original specification (US$ billion, 1990 prices)		As a percent of world GNP	
	High	Low	High	Low
Industrialized countries investment demand (+1 per cent)	145	145	0.7	0.7
Eastern Europe and CIS	393	47	1.9	0.2
LDCs (gap = requirements - 1990 transfers)	114	61	0.5	0.3
Middle East	17	17	0.1	0.2
UNCED	125	15	0.6	0.1
Total	794	285	3.8	1.4

Source: Table 3 and annex table A1.2.

capital-inflow induced income increases on savings rates and the effects of additional flows on world interest rates, growth in the creditor countries, trade, commodity prices, and so on.

It thus seems easy to dismiss proposals for mobilizing funds for the purposes listed above. Nevertheless, it cannot be denied that the listed numbers play a role of some influence in the international policy debate and that it is therefore useful to think through the implications for the world economy as a whole. Further, it remains useful to try and estimate the financing requirements to achieve particular policy targets (like a target GNP growth rate). In practice, growth objectives have been the residual of available finance. With the dismal growth performance of many developing countries in the 1980s, it seems reasonable that their policy makers would put forward claims on external financial resources which are derived from their growth and development targets. Probably, more research should be devoted to the improvement of the existing methodologies to estimate financial resource requirements. Given the likely magnitude of the estimates, a new method should comprise a global framework to take account of the direct and indirect international economic repercussions of *ex-ante* shifts in the distribution of global savings.

III. LDC financial market access, 'capital flight' and 'crowding out' of aid budgets

The central question is not, of course, whether or not there is a tendency towards an *ex-ante* global savings shortage, but what type of adjustment mechanism is set in motion and who gains and who loses in the process. Main-stream economic theory assumes savings and investment are a function of the real interest rate.[17] Under perfect market conditions savings, investment and the world interest rate would be determined simultaneously. An increase in the real interest rate would be associated with increased global savings and decreased global investment. In the absense of restrictions on international capital flows and the functioning of the global capital market, capital should flow to capital-scarce economies where the expected rate of return per unit of investment is highest. If these conditions hold, global savings would be allocated at the margin towards LDCs and Eastern Europe where capital-labour ratios are considerably lower than in the industrialized countries. This process would continue until expected real returns on investment are equated across countries.

New capital demands (or increased perceived investment opportunities) will, within this framework, push up real interest rates, but subsequently raise global savings, reallocate these to developing countries and Eastern Europe, and reduce investment demand in the industrialized countries. The more responsive global savings are to interest-rate changes, the quicker the adjustment and the smaller interest-rate movements are for a given shift in the investment demand function. Alternatively, if the supply of savings is relatively insensitive to the interest rate, as argued on empirical grounds in section I above, a relatively large increase in the cost of capital will be required with a relatively large diversion of investment resources away from the industrialized countries in order to satisfy capital demands in Eastern Europe and in the South. The interest-rate sensitivity of world savings and investment behaviour thus plays a critical role in determining the end-result. This determinant is also crucial in global macroeconomic models used for policy analysis. The implications are discussed in section IV.B.

Another critical assumption of the above-mentioned framework is that all capital is allocated internationally through an efficient global capital market leading to an equation of the (expected) rate of return (interest rate) across countries and regions. Nobody will disagree that this is too simplistic to fit stylized facts. Access of developing countries and Eastern European countries to private capital markets is limited. Developing countries face a segmented capital market. Four dimensions are briefly assessed below: (1) official flows; (2) commercial bank lending; (3) direct foreign investment; and (4) 'capital flight' from the developing countries.

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[17] The argument is set out also in recent studies such as Collins and Rodrik (1991) and Pauly *Transfers, Real Interest Rates and Regional Development: International Economic Implications of Financial Support for the Economies in Transition*, Studies for the Group of Twenty-Four (1992).

1. Official capital flows

A large share of capital flows to LDCs is provided by official sources, i.e. by Governments of the industrialized countries and multilateral organizations: most of which (about three-quarters) at concessional terms. These flows can be seen as a reflection of the limited access to LDCs to private sources of external finance and are largely motivated by (geo-)political and humanitarian considerations rather than by rate-of-return differentials.

2. Commercial bank lending

The experience with commercial bank lending to developing countries over the past two decades has taught that banks ration borrowers from poor countries. Credit availability from this source for developing countries has been shown to be insensitive to interest rates. Imperfect information impedes banks from properly assessing (current and future) creditworthiness of borrowers and from differentiating with precision between risk groups of borrowers. Instead of applying a risk premium on interest rates, credit ceilings are applied to minimize the risk of default of borrowers.[18] Fairly uniform and broad categories of borrowers are usually distinguished in the oligopolistically structured bank loan market, with the lowest ratings for borrowers having the highest risk. Some borrowers, including most low-income LDCs, are entirely excluded from this market. However, the experience of the 1970s and 1980s has shown that this was not a static market. Flooded with liquidity (in part from the deposit investments accruing from savings surpluses of major oil exporters), banks raised credit ceilings for groups of LDCs and, encouraged by high commissions to be earned, engaged in an oligopolistic competition for market shares.[19] Mainly middle-income countries benefitted from the easing of market access. The fear of a widespread debt crisis following Mexico's payment problems in 1982 changed bankers' market perceptions rather abruptly, leading to a lowering of credit ceilings to practically zero for most LDCs. Thus, a rise in world interest rates, even if it led to an increased supply of global savings, would do little to enlarge the flow of bank loans to developing countries. The climate of extreme political and economic uncertainty, the lack of institutions and legal arrangements protecting property rights and other factors, will probably render very limited the access of the economies in transition in Eastern Europe and the republics of the former Soviet Union to the bank loan market.

3. Direct foreign investment

Direct foreign investment (DFI) in developing countries has also been limited and behaviour of multinationals is guided by more factors than simple straightforward calculations of rate-of-return differentials at the margin.[20] Political and economic uncertainties impede flows towards capital scarce economies. The share of DFI in total capital transfers to developing countries increased during the 1980s (from around 10 to 30 per cent), but this was, besides an increase in absolute terms, to a large extent due to the decline and stagnation in other sources of finance. Recent growth of DFI (and portfolio investment) has given rise to some optimism about the return of developing countries to private capital markets (e.g. IMF 1991c). A closer look at the data tempers this enthusiasm. Table 4 shows that DFI to LDCs increased quite consistently in real terms over the past two decades, but nevertheless they lost share in global DFI (from 22 per cent in the late 1970s to 15 per cent in the late 1980s). The average growth rate of DFI to LDCs in the second half of the 1980s was below that of the first half. It should be noted, however, that much of the recent growth took place after 1988, so that the figures for the most recent trends could be somewhat under-estimated in table 4. Growth has been highly concentrated, however. Seven countries (China, Thailand, Malaysia, Republic of Korea, Brazil, Mexico and Argentina) received two-thirds of the total flow of DFI to LDCs between 1986 and 1990. Asia has been the most successful region in attracting DFI flows (see table 5), which has been attributed to the comparative success of the economies in East Asia in terms of growth and macroeconomic stability, the maintenance of labour-cost competitiveness and liberalization of investment regimes (particularly in China).

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[18] There now exists a wide body of theoretical literature on the rationing behaviour of banks in domestic and international credit markets. See e.g. Stiglitz and Weiss (1981), Eaton, Gersovitz and Stiglitz (1986), and Vos (1991).

[19] See Darity and Horn (1988), Devlin (1989) and Vos (1991) on the 'loan pushing' and oligopolistic bank firm competition that characterized the lending behaviour towards LDCs in the 1970s.

[20] Cf. e.g. Dunning (1981) for an authorative view.

Much of this also relates to shifts in the international distribution of labour in export industries competing with Japan, but also is a result of firms and investors in the Republic of Korea and Taiwan Province of China moving capital to the 'newer NICs' in the region (Thailand, Malaysia, China, Indonesia). DFI flows to Latin America had declined during the first half of the 1980s as a consequence of the economic crisis and instability related to the debt crisis. Flows later recovered, particularly towards Brazil, Mexico, Argentina and Chile. Only Mexico and Chile have shown significant economic recovery and stability in recent years, which may have been a factor in attracting DFI. In these countries the privatization of public enterprises and debt-equity conversion programmes seem more important. A return of 'flight capital' of their residents (see also below) has been an important source of finance behind the recent growth of DFI to these countries. Some observers doubt whether much 'additional' DFI has been attracted, if any at all.[21] DFI flows to sub-Saharan Africa have been very small (except to Nigeria) and have tended to decline. DFI to Eastern Europe has been modest so far; this is not surprising given the political and economic uncertainties. In sum, LDCs have not been able to benefit proportionally from the recent worldwide growth of DFI. DFI has tended to concentrate in countries where foreign exchange constraints are the least likely. With the possible exception of some Latin American countries, DFI is not likely to become a major source of finance for the regions with high capital requirements in the 1990s.

4. *Private capital outflows from LDCs*

A final point regarding the functioning of the global capital market relates to the large private capital outflows from developing countries over the past two decades. This phenomenon popularly became known as 'capital flight'. Standard theory would expect that under efficiently working markets there would be a capital flow towards capital-scarce economies; not two-way flows. Obviously then, imperfections exist. The rationing of official capital flows and commercial bank credits has been alluded to above. Moreover, these flows have concentrated in the public sector of developing countries.[22] It has been argued that the growth of the public sector debt overhang has been a determinant of private sector capital outflows (e.g. Eaton 1987). The high capital inflows of the 1970s would have been a source of exchange rate overvaluation and public external debt would be perceived by investors as a senior type of asset over domestic assets. Fears for a major devaluation and the risk of taxation or expropriation of domestic asset holdings would be driving forces of capital flight. Empirical investigation of the issue is seriously hampered by measurement problems. This is not the place to discuss these concerns, but clearly estimates of the magnitude and trends in private capital outflows from developing countries tend to differ significantly depending on the method applied.[23] Table 6 gives some plausible aggregate estimates for 1975-1985. It suggests capital flight has been most serious in the indebted Latin American countries with average annual outflows of US$10 to 15 billion between 1978 and 1985. The cumulative outflow for the region has been, according to the figures in table 6, almost equivalent to 40 per cent of the increase in outstanding long-term external debt between 1975-1985. Although much smaller in absolute terms, the ratio of the stock of private foreign assets to outstanding debt appears even higher for Africa (43.6 per cent). Capital flight from Asia is reported to be much less significant, the highly-indebted Philippines being a notorious exception (Vos 1992a). Even if the margin of error is considerable, these estimates suggest many developing countries may be much less foreign-exchange constrained than is often assumed, if they can find ways to repatriate these private asset holdings.

Insight into the actual driving forces behind private capital outflows could assist in identifying ways to stimulate such repatriation. Empirical evidence about the determinants is

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[21] See Lagos (1992) on the case of Chile, who argues that net new DFI may have been less with the debt-conversion programme than it might have been without.

[22] Some 80 per cent of the external debt of developing countries is held by the public sector (see Vos (1991) for a more detailed analysis).

[23] See Anthony and Hughes Hallet (1992) and Vos (1992a) for recent discussions and comparison of measures using different methods.

Table 4

FLOWS OF DIRECT FOREIGN INVESTMENT

(Annual averages, US$ billion, 1989 prices) [a]

	1970-1974	*1975-1979*	*1980-1984*	*1985-1989*
Inward flows				
To high-income countries	35.8	37.5	56.6	102.3
To LDCs	8.6	10.9	14.4	18.3
Outward flows				
From high-income countries	54.7	63.6	58.4	135.7
From LDCs	0.5	1.0	1.7	1.9
Discrepancy inward-outward	-10.8	-16.2	10.9	-17.0
Shares (per cent) of inward DFI				
To high-income countries	80	78	80	85
To LDCs	20	22	20	15
Average annual growth rates (per cent) inward DFI				
To high-income countries		1.0	8.6	12.6
To LDCs		4.3	5.8	4.9

Source: IMF, *Balance of Payments Statistics Yearbooks*; Bachman (1991).
a Current US dollars deflated by G-7 MUV index.

not univocal, but depends on country cases and the applied method of measurement. Four major determinants stand out:[24] (a) the real exchange rate (or the expectation of a major devaluation); (b) the (exchange-rate adjusted) real rate-of-return differential between foreign short-term assets and domestic financial assets (this determinant was not found significant for private capital outflows from Africa); (c) the availability of external finance (rather than the debt overhang itself, as was hypothesized above), which has been explained as a factor 'fuelling' capital flight; and (d) a target stock of foreign assets which has been associated with simultaneous consumption and portfolio decision-making by private agents, international lifestyles and consumption patterns of the rich in developing countries requiring substantial foreign exchange holdings.[25]

This set of determinants does not provide a clear guide for policy advice, even apart from the fact that the situation should be assessed for each individual country. Exchange rate adjustment and a rise in domestic real rates of return could be achieved through a package of adjustment policies. What does matter is stable and sustained positive returns on domestic assets over time. The latter condition clearly has prevailed in large parts of East Asia with low levels of capital flight. Chile and Mexico only achieved a return of flight capital after at least half a decade of stabilization and structural adjustment policies and implementation of an attractive debt-conversion programme. Repatriation of foreign assets in the Philippines is also associated with debt-equity swaps. Large debt conversion programmes may have undesirable macroeconomic effects (monetary expansion, inflationary tendencies, and possible negative balance of payments effects)[26] when the economy is still going through a process of adjustment towards stability and economic recovery. The positive correlation between capital flight and foreign capital inflows may imply new capital transfers should be discouraged. In the

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[24] Econometric studies can be found in, among others, Cuddington (1986), mainly referring to Latin American countries; Pastor (1990) also on Latin America; Hermes and Lensink (1990) on Africa; Anthony and Hughes Hallet (1992) on four major Latin American countries and the Philippines; and Boyce (1990) and Vos (1992a) on the Philippines. See also Vos (1991) for a further comparison.

[25] This point is made in Cuddington (1986) and Vos (1991, 1992a).

[26] See e.g. Lagos (1992) and Corden and Dooley (1989) for discussion of such issues.

Table 5

FLOWS OF DIRECT FOREIGN INVESTMENT TO LDCs, BY REGIONS

(Percentage shares)

	1970-1974	*1975-1979*	*1980-1984*	*1985-1989*
Africa	16.6	15.1	6.7	6.6
Asia	23.3	24.0	35.9	48.5
Europe, Middle East, North Africa	5.4	3.7	6.7	11.6
Latin America and Caribbean	54.7	57.2	50.7	33.3
Total	100.0	100.0	100.0	100.0

Source: See table 4.

past, overborrowing as much as outright corruption of government officials diverting foreign loans to private ventures[27] have been vehicles for capital flight. Probably this should be seen in the broader context of the economic environment. Where new moneys assist economic stability and recovery, they may be supportive of a repatriation of foreign assets in the medium run (as in the case of Mexico).

The characterization of the four capital market segments leads one to conclude that, for most developing countries, prospects for new capital transfers in the 1990s do not look very bright.

(a) A resumption of voluntary commercial bank lending is not a realistic prospect for most LDCs. Net resource flows from this source are still negative for most countries.[28] Positive net flows have been restricted to some Asian countries, but a major contribution is not to be expected for the 1990s. At best the larger middle-income countries may regain some access depending on their success with adjustment efforts and the reduction of their debt overhang.

(b) DFI and renewed LDC access to international bond and portfolio markets[29] have concentrated in a very small number of the larger and richer developing countries. Again success in the adjustment effort may assist in attracting additional finance in the medium term. Smaller and poorer countries, even if they stabilized successfully (like Bolivia), simply lack resource endowments or basic economic and social infrastructure to attract such funds.

(c) Similarly, repatriation of foreign assets held by private agents is probably in most cases not an important source of finance during periods of stabilization and adjustment, but more likely it could be a source of finance for the expansion that follows successful adjustment.

(d) Official flows will be for most countries the residual, but most important source of external finance in the 1990s. A major constraint on these flows will be formed by the budget constraints of the Governments in the industrialized countries, as discussed above. The Governments in the major economies may not give high political priorities to the developing countries. Negotiations at UNCED in Rio de Janeiro (June 1992) once more confirmed the difficulties of getting firm commitments of the donor countries for additional finance. A weak restatement of the old DAC target

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[27] Obviously, not much hard documented evidence is available on this subject. Boyce (1990) gives a well-informed account for the Philippines.

[28] See table 3 and World Debt Tables 1991-1992 and IMF (1991c) for details.

[29] See IMF (1991c).

Table 6

PRIVATE FOREIGN ASSET ACQUISITION ('CAPITAL FLIGHT') [a] BY LDCs, 1975-1985

(Billions of current US$, average annual flows)

	I	II	III	IV	V
	1975-1978	*1979-1982*	*1983-1985*	*Increase in stock since end-1974*	*Increase in stock (col. IV) as a percentage of growth of debt outstanding*
All LDCs [b]	5.9	27.8	16.3	183.6	28.1
Africa	1.7	4.1	1.8	28.5	43.6
Asia	-0.8	7.0	-2.2	18.3	12.6
EMENA [c]	1.3	2.0	5.7	30.2	17.9
Latin America	3.7	14.7	11.0	106.6	38.9

Source: IMF, *Balance of Payments Statistics*; Deppler and Williamson (1987); World Bank, *World Debt Tables*.

[a] Private foreign asset acquisition defined as net change in private external claims and measured on the basis of balance of payments statistics as net change in external liabilities (short and long-term) plus net direct foreign investment less current account deficit and less the change in official reserves and foreign assets acquired by the official banking sector.

[b] Excluding offshore banking centres.

[c] Europe, Middle East and North Africa (excluding major oil exporters).

of 0.7 per cent of GNP was agreed on without any solid commitment of the donors to meet that target before the end of the decade. Rather, existing aid budgets have been under serious strain to redirect funds towards Eastern Europe. Italy, which expanded its aid budget significantly during the 1980s, has already made a large reallocation in this sense. The aid budget of the Netherlands, generally considered one of the more generous donors favouring low-income recipients, has become subject to a similar political debate, although no major diversions have taken place so far.

The prospects for satisfying from international financial resources the new capital demands of both Eastern Europe and the South are thus not very bright. A 'crowding out' of demands from either region (or parts thereof) is a plausible scenario. However, even if aid flows from the rich countries were more forthcoming, it may be questioned whether this would have a favourable impact on the world economy as a whole and the developing countries, in particular, given the global capital market conditions discussed in section I above. This issue is treated in the next section.

IV. Global interactions

The global economic balances have shifted markedly over the past quarter of a century, as noted in section I. Throughout the 1990s and into the twenty-first century further major shifts seem to lie ahead. As also noted in section I, savings rates in the Northern economies are likely to decline in the medium to long run. This will put pressure on major fiscal adjustments in the Northern economies; otherwise higher and more unstable interest rates, lower private investment demand and growth are likely to dominate the global adjustment process. New capital demands for Eastern Europe, developing countries and the global environment will create pressure for further major shifts in global macroeconomic balances, even if the most modest estimates are taken (section II). Despite the return of some developing countries to private international capital markets, the role of private flows in satisfying the new demands is expected to be small and restricted to a limited number of countries. Demands for official and concessionary finance will thus put further pressure on the government budgets of the industrialized countries. A first plausible scenario is that budgetary problems in the rich countries will crowd out the finance needed for the global environment, development of the poor countries and capitalist reform in the former socialist countries. A second scenario could be that some new public money is made available, but accompanied by larger fiscal deficits and a crowding out of private investment demand in the industrialized countries. The aid-receiving countries in the developing world could eventually lose if financial instability and recessionary tendencies subsequently hit the world economy.

Why such pessimism? Would not new capital transfers stimulate trade and growth in the finance and foreign-exchange constrained economies with positive feedbacks on growth and savings elsewhere? Could the global adjustment process not be eased by looser monetary policies in the major economies, i.e. offsetting the upward pressures on real interest rates and recessionary tendencies? To answer these questions a global model is required. There is no consensus on the appropriate structure of such a model. Instead of presenting one particular model, outcomes of different types of existing models are compared. Section A below isolates the effects of an exogenous increase in capital transfers on international trade eastward and southward. Section B assesses the outcomes of several global macroeconomic models that focus on savings-investment and financial market linkages between the major economic regions of the world and the developing countries.

A. Aid transfers and trade linkages

The debt problem has brought the financial interdependence between industrialized and developing countries to the fore, but trade remains of course an important element in North-South relations. In 1987, industrialized countries exported about 2.7 per cent of their output to developing countries, while imports from them were about 3.1 per cent of industrialized country GDP. In 1980 ratios for both exports and imports were 3.9 per cent. The decline was mainly due to the fall in fuel and commodity prices in the 1980s (table 7). The traditional paradigm is that of developing countries as exporters of primary commodities and importers of manufactures. The share of manufactured exports in total exports of developing countries has increased significantly over the past two decades. Table 7 shows that manufactured imports from LDCs as a share of the GNP of industrialized countries increased four-fold since 1970, while total import coefficient increased by 50 per cent. Manufactured exports from industrialized countries to developed countries almost doubled as a proportion of industrialized country GDP between 1970 and 1980 (from 2.2 to 3.9 per cent), but fell during the 1980s. The latter trend is clearly linked to the debt crisis and the drying up of net financial transfers to developing countries and the import compression that formed part of the adjustment process many developing countries were forced to follow.

This raises the classic question of the relationship between trade and capital transfers and the extent to which trade and growth are stimulated world-wide by capital movements. The optimistic view, voiced some time ago (for instance in the Brandt Commission Report (Brandt 1980)), is that aid and capital transfers to developing countries would lead to higher global welfare as they would increase import capacity of these countries, enhance their growth potential and thus have a positive feedback on other countries through trade expansion. The underlying reasoning is based on extreme (Keynesian) assumptions, that is, a fully demand-driven global adjustment process and no endogenous price or interest rate effects.[30] There is a vast international economics literature showing welfare outcomes may be ambiguous once price and factor payment effects are accounted for.[31] The empirical relevance of the terms-of-trade, interest rate and financial market dynamic effects will be assessed through a number

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[30] See also Jayarwardena (1983) on this type of global Keynesianism which had many advocates at least until the early 1980s.

[31] See e.g. Eaton (1989) and Vos (1991) for surveys of this literature starting with the classic transfer debate.

Table 7

TRADE FLOWS BETWEEN INDUSTRIALIZED AND DEVELOPING COUNTRIES

	1970	1980	1987
	In billions of US$		
Exports of ICs to LDCs	48.1	304.1	334.7
Manufactures	39.2	243.1	277.5
Non-oil primary commodities	8.1	53.6	49.9
Oil	0.7	7.4	7.4
Imports of ICs from LDCs	42.5	313.4	390.0
Manufactures	8.6	91.1	217.9
Non-oil primary commodities	26.0	93.1	97.2
Oil	7.9	129.2	75.0
	In per cent of ICs GNP		
Exports of ICs to LDCs	2.2	3.9	2.7
Manufactures	1.8	3.1	2.2
Non-oil primary commodities	0.4	0.7	0.4
Oil	0.0	0.1	0.1
Imports of ICs from LDCs	2.0	3.9	3.1
Manufactures	0.4	1.2	1.7
Non-oil primary commodities	1.2	1.2	0.8
Oil	0.4	1.6	0.6

Source: Masson and Helliwell (1990) based on United Nations trade matrices.

of global macroeconomic models discussed in section B below. This section isolates the demand effects resulting from alternative allocations of increased net financial transfers from North to South and from North to East. It assesses the effects on world trade and the distribution of welfare effects over different country groups under varying assumptions about the way in which resources are mobilized in the industrialized countries in order to effectuate the increased transfers.

The analysis uses a simple linear world model based on a World Accounting Matrix (WAM). The WAM is a global accounting and data system which connects the external transactions (trade, finance and factor payments) of each economy with the internal balance (as reflected in the savings-investment balance) and identifies the interactions through commodity and financial markets between economies.[32] By presenting the accounting relations in matrix form the origin and destination of each international transaction can be identified. This of course requires a systematic cross-check of the consistency of data on commodity trade, balance of payments and national accounts across countries. The end result is a WAM which provides fully reconciled data for the world economy and includes mostly well-founded adjustments for the large world current account discrepancy which was pointed out earlier in section I.

A reconciled WAM for 1985 is included in annex table A1.3.[33] The WAM is based on a ten-region classification: four groups of industrialized countries (United States, Japan,

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[32] The structure and basic accounting principles of the WAM are explained in Vos (1992b) and in a special Appendix to this paper which is available from the author upon request.

[33] The WAM was constructed as part of a larger project on world accounting undertaken by the Finance and Development Research project of the Institute of Social Studies. WAMs with the same country group classification as annex table A1.3 have been constructed for 1970, 1975 and 1980 as well. See Luttik (1992) for all details. Currently, a series

European Community and Other OECD); one region for Eastern Europe and the former Soviet Union (former CMEA); one region of major oil exporters (MOE); three developing country regions classified by the nature of their external financial dependence (LDC-OB, DB and PB); and one region for the remaining countries of the rest of the world. A separate account for multilateral organizations (United Nations, IMF, World Bank, etc.) has been included as well. The classification for the developing countries was derived from the hypothesis that developing countries face a segmented world capital market, with some (mainly low-income) countries being heavily dependent on finance from official sources (i.e. 'official borrowers', LDC-OB) and others (mainly middle-income) with potential access to private sources of external finance ('private borrowers', LDC-PB). Countries with a more mixed external financing structure were labelled as diversified borrowers. WAMs with a country classification closer to those applied for the data presentations in the previous sections are still in the process of being constructed.[33] Roughly speaking, however, LDC-OB mainly consists of the low-income countries in sub-Saharan Africa and South Asia, while LDC-PB features most Latin American countries, most of East Asia and Nigeria and Zimbabwe in Africa.

Accounts 1-11 (annex table A1.3) represent consolidated current account transactions (merchandise trade, services, factor payments, current transfers) reading exports and factor incomes on the rows and imports and factor payments in the columns. Accounts 13-22 identify for each country group national savings and net increase in external liabilities (capital inflows) on the rows and domestic investment and acquisition of foreign assets (capital outflows) in the columns. Accounts for private and public consumption (23, 24) and change in reserves complete the system. (See Vos 1992b for further details and accounting identities.)

The WAM can be used as a basis for a linear model after separating endogenous and exogenous accounts. The method resembles the fixed-price multiplier model applied to Social Accounting Matrices (cf. Pyatt and Round 1979). For the present purposes, the regional current accounts (1-10) and private consumption (23) have been defined as endogenous (to changes in regional incomes). Multipliers were derived after estimating volume marginal import propensities and marginal consumption propensities.[34] Income changes as a result of exogenous demand injections (e.g. resulting from aid and capital transfers) can be estimated as:

$$dy = C\,dy + dx = (I - C)^{-1}\,dx$$

where C is the matrix of marginal propensities and dy and dx are changes in the endogenous and exogenous incomes respectively. The WAM model thus seems to be a quite appropriate tool to assess the global impact of increased aid transfers from North to South along the lines sketched by the Brandt Commission report. The model reproduces the extreme Keynesian assumptions of the report.

Twelve policy experiments are reported below. All simulations refer to the same aggregate transfer increase: development assistance flows to LDCs are increased to the level of the DAC target of 0.7 per cent of the GNP of the donor countries (i.e. doubled from the current level of 0.35 per cent). This 'injection' into the world economy compares to the lower bound estimate of financial requirements for developing countries in the 1990s discussed in section II (equivalent to about 0.4 per cent of industrialized countries' GNP). Of interest here, however, is the sensitivity of income changes to the allocation of these aid transfers among developing countries and to the type of budget-sharing in the industrialized countries.

At 1985 prices and exchange rates, the simulated additional financial transfer amounts to US$32 billion. Given their actual aid performance in 1985, this transfer will have to be generated among the OECD countries with the following distribution (in billions of US$):

United States	18.7
Japan	5.5
EC	6.1
Other OECD	1.7
Total	32.0

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of WAMs for 1985-1990 is being constructed using a 23-country group classification based on geographic criteria (G-7 countries are separate). See De Jong, Vos and Jellema (1991) for preliminary results.

[34] The marginal import propensities were estimated based on United Nations trade matrices series for 1968-1987. Detailed results are reported in Izurieta and Vos (1992). See also annex table A.2.

The twelve policy simulations differ by allocation among the LDC groups, the degree of diversion of aid flows to Eastern Europe and the way of financing in the OECD countries:

Ia: All aid is allocated to the low-income countries (LDC-OB) and no demand deflation (i.e. no budget constraint) in the OECD countries;

Ib: As Ia, but there is demand deflation (i.e. an imposed budget constraint) in the OECD countries;

IIa: Aid is more or less evenly distributed among the LDC country groups and no demand deflation (i.e. no budget constraint) in the OECD countries;

IIb: As IIa, but there is demand deflation (i.e. an imposed budget constraint) in the OECD countries.

IIIa: The entire increase in aid budgets is diverted to Eastern Europe and the former Soviet Union (CMEA) and no demand deflation (i.e. no budget constraint) in the OECD countries;

IIIb: As IIIa, but there is demand deflation (i.e. an imposed budget constraint) in the OECD countries;

IVa: Half of the increase in aid budgets is diverted to Eastern Europe and the former Soviet Union (CMEA) and the other half is entirely allocated to LDC-OB and no demand deflation (i.e. no budget constraint) in the OECD countries;

IVb: As IVa, but there is demand deflation (i.e. an imposed budget constraint) in the OECD countries;

Va: One-third of the increase in aid budgets is diverted to Eastern Europe and the former Soviet Union (CMEA) and the rest is entirely allocated to LDC-OB and no demand deflation (i.e. no budget constraint) in the OECD countries;

Vb: As Va, but there is demand deflation (i.e. an imposed budget constraint) in the OECD countries;

VIa: One-third of the increase in aid budgets is diverted to Eastern Europe and the former Soviet Union (CMEA) and the rest is distributed among the different LDC groups and no demand deflation (i.e. no budget constraint) in the OECD countries;

VIb: As VIa, but there is demand deflation (i.e. an imposed budget constraint) in the OECD countries.

In the case of the developing countries the optimistic assumption is applied that indeed the entire transfer will lead to an increase in expenditures. Some would even argue that aid tends to be even more expansionary, leading to complacency in the tax effort and more than proportionally increases government expenditures (Cf. e.g. Griffin 1970, 1986). A more pessimistic assumption from the perspective of global demand effects would be that developing countries apply balance-of-payments targets, e.g. as part of an adjustment programme agreed with the IMF or World Bank, and try to avoid a further widening of the external balance and thus cut domestic (government) spending to meet the external balance target. This case is not considered here.

With regard to the budget constraints of industrialized country Governments, two assumptions are applied. In one there are no financial constraints and in another the donor Governments pursue deflationary policies to effectuate the additional aid transfer. The first case is probably more in line with 'true' global Keynesianism in that the aid transfer is effectuated through (non-inflationary) deficit financing and demand effects. The crucial issue is that the international aid transfer not only has implications on the expenditure side of the government budget, but also requires a current account surplus (i.e. a savings surplus) in order to be effectuated. The simulations try to isolate this 'transfer problem' by assuming that in the case of no financial constraints (cases A) the transfer has no implications for aggregate government expenditures (i.e. the higher aid budget is funded from a budget reallocation), so that the exogenous demand effects in the OECD countries are zero. The implication is that the required savings and current account surplus will have to be generated through Keynesian income adjustment originating from the demand effects created in the aid-receiving countries. Obviously, these effects are immediate in the case of fully tied aid.

In the case with financial constraints (cases b), it is assumed that the donor Governments pursue deflationary policies to effectuate the aid transfer *ex ante* and negative exogenous demand injections are imposed on the four OECD economies of the size equal to the additional aid transfer that each is required to make to meet the DAC target. The simulation results are shown in table 8. The results are highly suggestive.

(a) Clearly a 'true' Brandtian global Keynesianism of mutually reinforcing aid, growth and trade seems possible in the cases in which the neglect of financial constraints can go unpunished (cases a). The highest endogenous world income growth is achieved, surprisingly enough, in the case in which the entire aid transfer is allocated to the low-income, aid-reliant countries (LDC-OB). Global income growth is about 1.1 per cent, which is three times the size of the exogenous demand injection. This might suggest that a potential 'virtuous circle' exists between world income redistribution towards the poorest nations and global economic growth. The result is surprising, given the rather low marginal import propensities of these countries.[35] However, a higher marginal consumption propensity than elsewhere and high indirect spending effects on the United States economy, which also has a lower marginal savings rate than the other major economies,[36] lead to the observed strong trade and income multipliers of this group of countries.

(b) Further, the aid transfer generates strong redistributive effects in favour of the aid recipient countries. Among the donor countries, the EC tends to be the largest beneficiary in the case with no financial constraints and all aid flowing to LDC-OB (Ia). This is remarkable in the light of the earlier observation that the United States showed higher multiplier linkages with the developing countries than any of the other industrialized country groups. The final result may be explained by larger overall international linkages of the EC. However, the outcome is somewhat different if the aid transfer is more evenly distributed among the LDCs (case IIa), as this seems to lead to slightly lower income effects in the United States and the EC, making Japan the main beneficiary among the donor countries.

(c) If the donor countries pursue deflationary policies to effectuate the aid transfer, world income growth is strongly depressed. The donor countries plunge into a recession, and the income effects in the rest of the world are severely dampened. For the world as a whole, this way of financing the aid transfer is almost a zero-sum game as world income growth is negligible (i.e. near zero) and smaller than the size of the transfer. The trends and distributive effects are similar to the case without financial constraints.

(d) Diversion of aid transfers to Eastern Europe generates lower income effects (simulations IIIa versus I-IIa). Global income effects improve the more aid is allocated to low-income LDCs (IV-VIa). If there is diversion towards Eastern Europe and the additional aid transfers are financed out of demand deflation in the industrialized countries, non-recipient countries may even suffer welfare losses (IVb, VIb). These effects are of course based on the historical spending behaviour of the former CMEA countries showing relatively low domestic demand multipliers and less integration into the global trading system. These conditions are now subject to change. Likely the transformation process will be slow, so that estimated multipliers may remain of some relevance in the medium run.

As indicated, the linear WAM model isolates demand effects, but ignores endogenous price effects and endogenous global financial interactions. It would be hazardous to draw strong policy conclusions from such a model system, even though the model conclusions may

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[35] Bilateral marginal import propensities (out of real income) are not significantly different from zero for most trading partners, suggesting import demand is foreign exchange constrained for this group of countries rather than that income growth feeds back into trade.

[36] See Izurieta and Vos (1992, forthcoming) and a special appendix to this paper which is available from the author upon request.

WAM-MODEL 1985: POLICY SIMULATIONS INCREASE IN AID TRANSFERS TO REACH DAC TARGET OF 0.7 PER CENT OF GNP

			Exogenous demand injections (US$ billion)											
		Original income	*Ia*	*IIa*	*Ib*	*IIb*	*IIIa*	*IVa*	*IIIb*	*IVb*	*Va*	*VIa*	*Vb*	*VIb*
United States	1	4463	0.0	-18.7	0.0	-18.7	0.0	-18.7	0.0	-18.7	0.0	-18.7	0.0	-18.7
Japan	2	1506	0.0	-5.5	0.0	-5.5	0.0	-5.5	0.0	-5.5	0.0	-5.5	0.0	-5.5
EC	3	3518	0.0	-6.1	0.0	-6.1	0.0	-6.1	0.0	-6.1	0.0	-6.1	0.0	-6.1
OOECD	4	1215	0.0	-1.7	0.0	-1.7	0.0	-1.7	0.0	-1.7	0.0	-1.7	0.0	-1.7
CMEA	5	951	0.0	0.0	0.0	0.0	32.0	32.0	16.0	16.0	10.0	10.0	10.0	10.0
MOE	6	545	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
OB	7	539	32.0	32.0	11.0	11.0	0.0	0.0	16.0	16.0	22.0	22.0	10.0	10.0
DB	8	682	0.0	0.0	11.0	11.0	0.0	0.0	0.0	0.0	0.0	0.0	6.0	6.0
PB	9	1103	0.0	0.0	10.0	10.0	0.0	0.0	0.0	0.0	0.0	0.0	6.0	6.0
ROW	10	281	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
C_p	23	7418	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total		22221	32.0	0.0	32.0	0.0	32.0	0.0	32.0	0.0	32.0	0.0	32.0	0.0

		Simulation results (per cent change in endogenous income)											
		Ia	*IIa*	*Ib*	*IIb*	*IIIa*	*IVa*	*IIIb*	*IVb*	*Va*	*VIa*	*Vb*	*VIb*
United States	1	0.80	-0.25	0.65	-0.40	0.42	-0.62	0.61	-0.43	0.68	-0.36	0.60	-0.45
Japan	2	1.30	-0.10	1.07	-0.33	0.69	-0.72	0.99	-0.41	1.11	-0.30	0.98	-0.43
EC	3	0.47	-0.11	0.38	-0.20	0.25	-0.33	0.36	-0.22	0.40	-0.18	0.35	-0.23
OOECD	4	1.14	0.07	0.92	-0.15	0.60	-0.47	0.87	-0.20	0.97	-0.10	0.85	-0.22
CMEA	5	0.88	0.19	0.71	0.02	3.83	3.14	2.35	1.67	1.80	1.11	1.70	1.02
MOE	6	0.90	0.20	0.73	0.03	0.49	-0.20	0.69	0.00	0.77	0.07	0.68	-0.02
OB	7	6.26	6.02	2.29	2.05	0.17	-0.07	3.21	2.98	4.36	4.12	2.08	1.85
DB	8	0.64	0.12	2.13	1.60	0.34	-0.19	0.49	-0.04	0.55	0.02	1.36	0.83
PB	9	0.26	0.04	1.13	0.91	0.14	-0.08	0.20	-0.02	0.22	0.00	0.75	0.53
ROW	10	-0.14	-0.06	-0.14	-0.06	-0.12	-0.04	-0.13	-0.05	-0.13	-0.05	-0.13	-0.05
C_p	23	1.32	0.29	1.06	0.04	0.70	-0.33	1.01	-0.02	1.12	0.10	0.98	-0.05
Total		1.07	0.19	0.89	0.02	0.63	-0.24	0.85	-0.03	0.93	0.05	0.83	-0.05

Note: See text for description of simulations and annex table A1.3 for description of account names.

be helpful as partial answers. Looking at the global demand effects of additional aid transfers, the above simulations suggest that the highest positive gains, both in terms of global income effects and in terms of income redistribution towards the poorest nations, may be expected if additional aid transfers are directly allocated towards these countries. Diversion towards Eastern Europe would imply lower global income effects. This is only part of the story, however. In the next section a more complete picture is drawn, taking account not only of trade-income multipliers but also of endogenous price effects and endogenous financial linkages.

B. Trade, aid and finance in global macroeconomic models

1. Models emphasizing trade linkages

Considerable empirical macroeconomic research has been done on the current account and fiscal linkages among the industrialized countries (Bryant *et al.* 1988), but much less empirical analysis using multi-country general equilibrium models of the linkages between industrialized and developing countries. Much of the traditional literature on interactions between North and South has been concerned with trade and with growth and development of the South.[37] Empirical models of the world economy including the developing countries have emphasized trade linkages.[38] The better known model systems include Leontief's regional world model, the World Bank's SIMLINK, OECD's INTERLINK, Project LINK and the FUGI model.[39] These models have in common the fact that international linkages are determined through trade matrices. The Leontief regional input-output system assumes fixed prices, but the other systems specify market-clearing price adjustment for various commodities. Linkages between North and South thus not only depend on income growth and demand functions for each other's exports, but also on terms of trade effects. Another noteworthy common feature of these models is that they assume developing countries are foreign-exchange-constrained economies. That is, developing country growth and demand for industrialized countries' exports are constrained by import capacity, i.e. export earnings plus capital inflows.

Capital flows and global financial interactions are not explicitly modelled in these systems.[40] Usually capital flows from industrialized to developing countries are set exogenously thus determining their import capacity. Net capital movements between other countries and regions are equated with their respective net trade or current account balances that result from general equilibrium income and price effects.

These models have been used among other things to project trends in world economic growth, trade and commodity prices under different policy assumptions. They have also been used to estimate capital requirements for developing countries for specified growth targets, i.e. providing a global framework for the type of two-gap model estimations discussed in section II above. They can also be used to assess the effects of increased aid flows and alternative allocations as done above using the WAM-multiplier model. Some simulation excercises using the Project LINK model system are discussed below. Gregory (1992) reports on some recent simulations of the global effects of a doubling of Japanese aid using the FUGI model. These simulations confirm the sensitivity of the size and distribution of global welfare effects following increased aid transfers to the way these are financed in the donor countries and how these are allocated among developing countries.

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[37] See Findlay (1984) and Ocampo (1986) for reviews of that literature.

[38] See Hickman (1987) for a good review.

[39] See Leontief *et al.* (1977) on the Leontief regional world model; Hicks *et al.* (1976) and Waelbroeck and Tims (1982) on SIMLINK; OECD (1982) and Richardson (1987) on INTERLINK; Filator, Hickman and Klein (1983) and Hickman (1987) on the country models and global linkage system coordinated through the project LINK; and Onishi (1981) on the FUGI model.

[40] The FUGI model does model private direct investment abroad, which is a function of the level of GDP, the share of profits, wage costs (adjusted for labour productivity) relative to the world level, and exchange rate movements, all variables of the debtor country. Also portfolio investment is modelled explicitly as a function of interest rate differentials between capital-importing and exporting countries, exchange rates, and profit shares.
The level of ODA flows is given as a fixed proportion of donor country GDP, while also the allocation across LDCs is set exogenously. The overall trade and current account adjustment is eventually no different from that explained in the text, i.e. the remaining other capital flows accommodate trade and current account imbalances.

Table 9 summarizes the results. It shows that:

(a) A 'budgetary neutral' aid increase (financed through cut-backs on other government expenditures, defence in particular) yields a small, but positive global welfare effect: global GDP would increase by 0.023 per cent, less than the original injection. The initial injection is about US$10 billion (doubling of existing Japanese ODA) or about 0.04 per cent of world GNP. The implicit trade-income multipliers assumed by the FUGI model thus appear smaller than those calculated by the WAM-multiplier model, which may have to do with the inclusion of endogenous price effects.

(b) Much of the positive world growth effect disappears if the Japanese aid increase is financed through demand deflation (via a tax increase). The model suggests GDP growth in the OECD countries would fall and thus reduce income growth effects for the developing countries.

(c) Global growth remains positive if the existing East-Asian concentration in the allocation pattern of Japanese aid is maintained (with Indonesia, China, Philippines and Thailand receiving almost half). Contrary to the findings of the WAM model trade multipliers, a bias in the allocation towards the low-income countries (China, India and Africa receiving about two-thirds) yields a global welfare loss if financed by increased taxation. This outcome has to do with (i) the model's parameter assumptions showing lower growth responses to increased capital inflows in India and China than Indonesia, Philippines and Thailand; (ii) the new geographical distribution of aid which is applied to the entire Japanese budget, meaning that, compared to the baseline, aid flows towards the dynamic East-Asian economies are actually reduced; and, likely, (iii) unfavourable terms of trade effects (not included in the WAM model) following demand deflation in the OECD countries appear stronger for (primary-exporting) low-income countries.[41]

The differences in results between the FUGI and the WAM model underline the importance of carefully checking the structure of the model before using simulation results as a guide for policy-making. They also show that there is still considerable scope for debate about the empirical validity of the precise multipliers determining size and direction of the key international economic linkages.

2. *Global macroeconomic models emphasizing financial linkages*

Over the past decade, much more empirical work has been done on the analysis of global macroeconomic interactions. The growth of international financial markets has emphasized the important international repercussions of fiscal and monetary policies. Private capital flows (bank credits) to developing countries also grew, but at the same time the crisis in their ability to service their debts in the 1980s affected their access to these flows and hence their import capacity. This makes clear that capital flows have their own determinants and that finance may be driving trade balance adjustment rather than vice versa.

Very few empirical global general equilibrium models capture capital flows and macroeconomic linkages between industrialized and developing countries. Much of the research has been confined to linkages between the industrialized countries (see e.g. Bryant *et al.* 1988). Discussion of recent work on rather aggregate models of North-South macroeconomic interactions can be found in Currie and Vines (1988), Vines and Muscatelli (1989) and Vos (1991). Only a few models will be discussed here. They could be seen as representative of the state-of-the-art. The main focus will be on the IMF's MULTIMOD (Masson, *et al.* 1988; Masson, Symansky and Meredith 1990; IMF 1991d) and the MSG2 model developed by McKibbin and Sachs (1991). MULTIMOD is an important tool for the policy analyses underlying the IMF's world economic outlook. MSG2 was sponsored by the Brookings Institution. To highlight the relevance of certain theoretical assumptions, further reference is

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[41] The price effects are not explicitly discussed in Gregory's assessment.

Table 9

FUGI MODEL: GLOBAL IMPACT OF DOUBLING JAPANESE AID FLOWS

(Change in GDP growth rates vis-à-vis baseline, in percentages)

		Existing aid allocation		*Aid biased to LICs*
	Baseline GDP growth rate	*Budget neutral* *I*	*Tax increase* *II*	*Tax increase* *III*
World	3.0	0.023	0.010	-0.003
OECD	2.7	0.003	-0.009	0.000
Japan	4.0	0.006	-0.064	0.000
Asia	5.7	0.253	0.241	-0.043
East Asia	6.0	0.025	0.013	-0.004
Indonesia	5.1	1.820	1.775	-0.561
China	4.8	0.021	-0.014	-0.003
India	4.8	0.020	0.019	0.082
Africa	n.a.	n.a.	n.a.	n.a.
Egypt	2.5	0.002	-0.001	0.002
Nigeria	5.5	0.002	0.002	0.004
Other Africa	3.3	0.000	0.000	0.000
Latin America	n.a.	n.a.	n.a.	n.a.
Brazil	4.6	0.004	0.000	0.000
Mexico	3.9	0.002	-0.003	0.000
Other Latin America	3.7	0.000	0.000	0.000

Source: Gregory (1992), preliminary results.

Note: Doubling Japanese aid is equivalent to exogenous injection of about US$10 billion (1990) or about 0.04 per cent of world GNP and 0.06 per cent of OECD GNP.

Scenarios:

I: Aid increase financed through budget cuts (defence expenditures); allocation according to 1989 Japanese aid allocation.

II: Aid increase financed through tax increase; allocation according to 1989 Japanese aid allocation.

III: Aid increase financed through tax increase; allocation biased towards low-income countries on the basis of income gap with respect to "low income threshold" of US$1380 in 1988; reallocation confined to current aid recipients.

made to a small North-South model (STAC) which, in the tradition of the theoretical literature, assumes rather strong structural behavioural differences in trade and financial adjustment between the two regions. Further, some reference will be made to the large LINK project model system which connects about 80 country models. Rather than being comprehensive, the main purpose of this comparative analysis is to undo empirical global models from the 'black box' vignette these have in the minds of many policy-makers.

Both MULTIMOD and MSG2 differentiate the major industrialized countries. They have a simple aggregate country model for high-income oil producers and have grouped all net debtor developing countries into one region. Trade of developing countries is disaggregated into three types of commodities: oil, other primary commodities and manufactures. This way the importance of terms of trade changes is captured, as well as the reality that developing countries not only export primary products but also manufactures. The STAC model has only one aggregate industrialized country model, but also distinguishes a major oil-exporters region and one aggregate developing country region. In contrast to the other two models, it assumes complete trade specialization between the regions in the tradition of the theoretical North-South literature: the North producing and exporting manufactures; the South primary products.

The key assumptions determining the global linkages captured by these models may be summarized as follows:

- ***Prices and terms of trade:*** Prices are fully flexible on all markets in the MSG2 model. In both MULTIMOD and STAC the price of oil is fixed, primary commodity prices are flexible and market-clearing, while producers of manufactures are assumed to exercise a considerable degree of market power. The price of manufactures is thus determined by a mark-up pricing rule over production costs. In MULTIMOD each country (region) can price its manufactured good differently. In STAC, given complete specialization, these assumptions make the North a fixed-price, demand-driven economy and the South a supply-constrained economy vulnerable to commodity price fluctuations. Although less straightforward, this asymmetry is also apparent in MULTIMOD as developing countries turn out to be, on balance, net primary exporters.

- ***Private savings and investment:*** The modelling of the industrialized economies in MSG2 and MULTIMOD follows the basic outline of a dynamic version of the Mundell-Fleming model for open economies, but allows for rational expectations in determining portfolio behaviour in financial markets. Private savings are determined through household-consumption demand, which is a function of current income growth, net wealth and (in MULTIMOD only) also demographic change. This savings behaviour relates to the discussion in section I.B. The real interest rate affects expected future consumption, the discounted value of wealth and the propensity to consume out of wealth. Higher interest rates are expected to reduce current consumption and thus enhance private savings. STAC in contrast assumes a post-Keynesian savings function, making private savings insensitive to interest rate changes and rather a function of income distribution and firms' self-financing decisions. Equally in STAC, Southern private savings are a function of income distribution (with profits driven by the terms of trade). In MULTIMOD, developing country savings depend on disposable income. MSG2 does not specify a Southern savings function. The determination of investment demand in the industrialized countries runs down in all three models being a positive function of firm profitability and depending negatively on the real interest rate (through Tobin's q framework). Southern investment and output are also treated similarly in all three models as being finance-constrained (by domestic and foreign savings).

- ***Capital flows:*** MULTIMOD, MSG2 and STAC all assume that the global capital market is segmented. This is very much in line with the argument in section III, although it is noted that MULTIMOD and MSG2 only model one aggregate type of capital transfer to the South (with specific reference to commercial bank lending), while STAC models aid transfers, bank credits and 'capital flight'. In all three models, Northern investors have unconstrained access to finance, but Southern Governments and private investors are constrained by credit rationing rules. McKibbin and Sachs simply set the scale of borrowing by LDCs exogenously under the assumption that the amount of loans available to these countries is rationed by considerations of country risk. In MULTIMOD, financial flows between industrialized and developing countries are assumed to depend on LDC ability to service debt. The measure of payment ability is the interest payments-to-export ratio evaluated at expected real interest rates and exports in the future. Because of forward-looking elements, this ratio is seen as a measure of solvency rather than of liquidity. No demand function for loans is specified, but it is implicitly assumed that borrowers apply exactly the same solvency criterion to manage their external debt. They are further implicitly assumed to honour faithfully debt contracts and allow a negative transfer if new lending falls short of payment obligations. The possibility of default is not considered. In STAC a debt crisis may occur because lenders and borrowers behave differently. Lenders apply a solvency criterion to assess creditworthiness (based on LDCs' debt/export ratio), as in MULTIMOD, but are also assumed to raise credit ceilings for LDC borrowers if the international banking systems tends towards excess liquidity.[42] Creditors cannot be expected to be able to predict with any precision future interest rates and LDC export earnings, so that their creditworthiness assessment is imperfect. LDC borrowers (mainly governments) are seen to manage debt rather as a form of foreign reserve management (liquidity needs) than with an eye on solvency. If debt servicing surpasses a critical percentage of foreign exchange earnings, they will consider (partial) default. In STAC an actual debt crisis may result; an option not considered by the other models. The STAC model also considers 'capital flight', i.e. acquisition by private agents of assets in industrialized countries. This capital flow from South to North is assumed to be determined by exchange rate adjusted rate-of-return differentials between domestic and foreign assets and asset targets, thus partly reflecting the type of determinants discussed in section III.

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[42] This way of modelling lenders' behaviour rests on a theory of oligopolistic competition between bank firms which try to maximize market shares under restrictions of (imperfect) creditworthiness assessment. See also the discussion in section III.

What global adjustment effects do these models predict in response to an increase in capital flows to developing countries? The short answer is that these will depend on the macroeconomic policies in the industrialized countries accompanying the additional transfer. The direct effect of enhanced capital flows on income growth is positive, as these models assume developing country investment and growth is foreign- exchange constrained. However, this positive effect may be fully offset as soon as global general equilibrium effects are taken into account. The key linkages are summarized in table 10. Given the structure of these models, the key variables determining the outcome for growth in the developing countries are:

(a) GNP growth in the industrialized countries (Y_{oecd}), which is the main determinant of demand for LDC exports (and import capacity).

(b) World interest rate (r), which affects the savings-investment process as well as the growth rate in the major economies and affects the debt service burden of the indebted developing countries and so their import capacity, growth, access to new lending (MULTIMOD) and probability of default (STAC).

(c) The terms of trade (tot) of the developing countries which is an important determinant of their export earnings and domestic savings (MULTIMOD, STAC).

(d) GNP growth rate of developing countries (Y_{ldc}) which has a feedback on the terms of trade (supply effect) and LDC savings.

Table 10 summarizes the signs of the adjustment of these key variables for a few relevant and comparable simulations executed with these models. The effects are shown for the short-run (1-year simulation) and medium-run (5-year simulation). The outcomes are broadly similar:

(a) *OECD fiscal expansion*[43] *(bond-financed, i.e. with unchanged monetary policies)*

In the short-run, MSG2 and MULTIMOD predict aggregate demand expansion in the North and an increase in real interest rates. In MULTIMOD, the spill-over effect on LDCs is initially positive: Northern expansion increases demand for LDC exports, leading to a terms-of-trade improvement and higher growth. However, in the medium run these positive effects disappear as higher interest rates have a negative impact on aggregate demand in the North, eventually leading to a fall in the terms of trade and lower growth in both North and South. McKibbin and Sachs do not report welfare effects for the South, but OECD growth and the terms of trade should be indicative. In year-5, similar results are obtained as with MULTIMOD; in year-1 a terms of trade deterioration is reported[44] suggesting an ambiguous effect on the Southern growth rate. In the STAC model, the negative repercussions on global demand and Northern investment are immediate, suggesting the fiscal impulse resulting from increased aid budgets may even lead to welfare losses in the South in the short run.

(b) *Alternative ways of financing the aid increase*

(I) Bond-financed

This way of financing the aid increase shows global adjustment effects similar to

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[43] The table refers to the effects of United States fiscal expansion, but a combined fiscal expansion in the major OECD countries yields similar overall outcomes.

[44] This is probably explained by the cost-push effect of rising intermediate import costs in the OECD resulting from rising LDC export prices. McKibbin and Sachs do not provide an explanation.

Table 10

GLOBAL MACROECONOMICS: COMPARISON OF GLOBAL MODEL RESULTS SENSITIVITY OF KEY AGGREGATES TO UNITED STATES FISCAL EXPANSION, OECD MONETARY EXPANSION, BOND-FINANCED AND BUDGET-CUT FINANCED AID TRANSFERS TO LDCs

(Indicated effects as deviation from baseline case of respective models)

	Year-1				Year-5			
	Y_{oecd}	r	tot	Y_{ldc}	Y_{oecd}	r	tot	Y_{ldc}
Effects of United States fiscal expansion								
MSG2	+	+ +	-	(+/-) [a]	0	+ +	-	(-) [a]
MULTIMOD	+	+	+	+	-	+	-	-
STAC	-	+	-	-	--	+	--	--
Effects of increase in aid to LDCs								
I. Bond-financed								
MULTIMOD	+	+	+	0	-	+/-	-	0
STAC	-	+	+	-	--	+	-	--
II. Monetary expansion OECD								
MSG2	+	-	+	(+) [a]	0	0	-	(-) [a]
MULTIMOD	+	-	+	+	-	+	0	-
III. Budget cuts								
STAC	+	0	+	+	+	0	-	+

Source: MSG2: McKibbin and Sachs (1991); MULTIMOD: Masson *et al.* (1988), Masson, Symanski and Meredith (1990) and Masson and Helliwell (1990); STAC: Vos (1991, 1992).

Note: Y_{oecd} = OECD growth rate; Y_{ldc} = LDC growth rate; r = international interest rates; tot = terms of trade of developing countries.

++ = strong positive effect
+ = positive effect
-- = strong negative effect
- = negative effect
0 = neutral (or near zero) effect
+/- = ambiguous effect, positive and negative, in major economies within the group (OECD or LDC)
[a] Expected outcome. Effect not reported by source.

bond-financed fiscal expansion in the North, as explained above. Global macroeconomic repercussions of higher real interest rates would tend to offset the direct positive income effects for the recipient countries of an increase in aid transfers.

(II) Monetary expansion

The option of financing additional concessional flows to developing countries by relaxing monetary targets in the industrialized creditor countries might look appealing from the perspective of developing countries. Likely, real interest rates would drop, thus stimulating aggregate demand expansion in the North and exports from the South and reducing the debt service burden of developing countries. An offsetting effect could be a terms-of-trade deterioration as a consequence of an acceleration of Northern inflation. As indicated in table 10, simulations with MSG2 and MULTIMOD[45] confirm these expected global adjustment effects for year-1. In the medium run, however, these effects tend to reverse and the positive impact on the developing country disappears. In the medium run inflation hampers an acceleration of Northern growth in these models. In particular, besides affecting international competitiveness, the decline in real interest rates affects private savings while investment demand goes up. Upward pressure on the long-term real interest rate eventually leads to a stagnation of growth in the North.

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[45] The present version of the STAC model does not specify a monetary base.

(III) Budget cuts

Simulations with the STAC model suggest that the most advantageous option for developing countries would be to finance the aid increase out of a reduction of other budget items. This would avoid upward pressures on real interest rates and consequent global demand deflation. No comparable simulations with MSG2 and MULTIMOD were available, but from the previous analysis one might expect these models to yield a similar outcome. One of the obvious candidates for achieving additional fiscal adjustment would be defence expenditures. The simulation experiments with global models (see also the simulations with the FUGI model above) suggest that cashing the 'peace dividend' for the developing countries will benefit both North and South.[46]

The simulation results of the models reviewed here are thus broadly the same. Recent experiments with the LINK global model system on the global repercussions of enhanced capital transfers to Eastern Europe and the CIS have yielded largely similar types of results (Pauly 1992). Increased capital transfers for Eastern Europe under conditions of restrictive monetary policies (that is maintaining baseline monetary targets) would raise nominal interest rates, but substantial trade stimulus from there would lead to a small GNP gain in the OECD as a whole in the short run. In the medium run, aggregate demand deflation because of higher interest rates would offset the trade stimulus (particularly due to recessionary tendencies in the United States which is expected to benefit less from trade expansion with Eastern Europe). Developing countries are expected to gain slightly from the trade expansion. But the gains are distributed unevenly: the Asian NICs take most of the gain, while the indebted countries in Latin America and Africa are the losers over the medium term as a consequence of a higher debt service burden. The LINK simulations suggest benign outcomes may be expected from a relaxation of monetary targets in the OECD countries. Capital transfers to Eastern Europe accompanied by monetary policies that would (successfully) target stable interest rates would have a stimulating impact on world economic growth, including LDC growth.

Compared to the simulations with the WAM-model, the LINK projections are optimistic about trade stimulus following capital transfers to the East. The WAM-model was based on historical patterns which are likely to be too pessimistic. However, until "the dust has settled" in Eastern Europe, it is difficult to estimate how optimistic one may be about trade expansion from these countries in the 1990s. Simulations with monetary expansion do not immediately compare to the corresponding simulations with MSG2 and MULTIMOD, as the latter do not specify a specific target with regard to interest rates. Nevertheless, the resulting acceleration of OECD inflation would in these models likely produce a less optimistic world economic outlook (similar to that reported in table 10) than that projected by LINK.

An advantage of the LINK system is that it provides more country detail than any of the other models discussed. At the same time, however, the system links about 80 rather heterogeneous country models, which makes the model's workings difficult to track. As indicated, economic interdependence between the countries is modelled through trade. Financial linkages are not explicitly modelled. National monetary and fiscal policies spill over to other countries through the effects on import demand and commodity prices. Changes in external financial asset positions like in MSG2, MULTIMOD and STAC play no role. Despite the similarities in the results of these latter three model systems, there are important differences. One important feature is stressed which has to do with potential international financial instability that might be an undesired consequence of world-wide shifts in capital transfers.

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[46] The option of a tax-financed aid increase in not discussed here. Only experiments with the STAC model are available. These suggest Northern demand deflation following a tax increase is significantly less than that resulting from a higher world interest rate. As a consequence, the South gains from an increased aid transfer, albeit suffering some terms of trade losses. See Vos (1991, 1992b) for a further discussion.

The responsiveness of global savings and investment plays a crucial role in the equilibrium adjustment of the models discussed here. Two related points of debate should be mentioned. First, the models show significant differences in empirical estimates of the elasticities of the savings and investment response to interest rate changes. Secondly, existing empirical global models underscore the potential danger of global financial instability owing to interest instability and shifts in net asset position between major economic regions.

3. *Interest rate instability?*

With regard to the responsiveness of macroeconomic balances to interest rate changes, the first versions of MULTIMOD show for the industrialized countries a very high responsiveness of savings and investment to the rate of interest. Particularly, the responsiveness of private savings is very high (e.g. for the United States the positive elasticity is about 6.0). Private investment also strongly responds to interest rate changes (between -3.0 and -4.0). This implies that an *ex-ante* savings-investment gap in the major economies only requires a relatively small change in the rate of interest. MULTIMOD MARK-II simulates that a bond-financed United States fiscal expansion of 1 per cent of GNP (equivalent to an annual exogenous injection for the global economy of about US$50 to 60 billion) would require a real interest rate increase of 0.3 percentage points to restore global macroeconomic equilibrium (see annex table A1.4). High interest-rate elasticities assumed in other empirical models for industrialized countries yield a similar result.[47] MSG2, LINK and STAC, in contrast, suggest much lower elasticities. MSG2 shows an elasticity for private savings of around 1.0 and of private investment of around -0.8. These elasticities suggest much flatter supply and demand curves for global savings and an imbalance requires much larger interest rate adjustment. In MSG2, the same United States fiscal expansion yields a real interest rate increase of 1.3 percentage points (annex table A1.4).[48] A similar 'global injection' yields in LINK a nominal interest rate increase of about 100 basis points (and about 50 in real terms) (Pauly 1992). The most recent version of MULTIMOD (IMF 1991d) includes substantial adjustment of the coefficients determining the elasticities of savings and investment to real interest rate changes. These are now much closer to the values used in MSG2 (around 1.0 and -1.0 respectively), suggesting significant interest rate increases may result from increases in concessional capital transfers to East and South if financed in the industrialized countries out of their government budgets without compensatory macroeconomic policy adjustment.

In sum, there appears to remain some scope for debate on the empirical values of critical parameters of global models. Differences in trade multiplier estimates were also discussed above. These matters may be resolved through further empirical work, but for the time being more or less optimistic outcomes with regard to interest rate instability, trade adjustment, etc. will be critical to policy guidance. How important this can be is shown by the early projections of the world economic outlook in the immediate aftermath of the debt crisis. Optimistic forecasts of the IMF (e.g. IMF 1984) and Cline (1983, 1984) strongly influenced the perception among international policy-makers that the crisis was temporary and purely a problem of liquidity. The international debt management strategy was designed in the first crucial years in this vein.[49] The author's own perception is that with regard to the interest-rate elasticity, a pessimistic inclination seems justified, i.e. the savings responsiveness to interest rates is rather small and that, all other things being equal, large capital transfer injections on the scale referred to in this paper are likely to provoke large interest rate adjustments and instability. This point of view is strengthened, of course, with the recent modification of the relevant parameters of IMF's MULTIMOD.

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[47] In table 12 the column 'other' refers to mean estimates for seven other multi-country empirical macroeconomic models. These focus on linkages between industrialized countries only. The models included are DRI, EEC, INTERMOD, MCM, MINIMOD, OECD and TAYLOR. See Bryant, *et al.* (1988) for a further discussion.

[48] In the STAC model, the Northern savings rate is little sensitive to the interest rate, though it will rise with the share of net interest income on assets and liabilities in total private income. The investment response has an elasticity of -1. However, since STAC assumes a more instantaneous adjustment of Northern GNP and investment demand to interest rate changes, the *ex-post* interest rate change is smaller than in MSG2, but analysis of the iteration steps suggest the real interest rate initially tends to move upward by about 1 percentage point following a bond-financed injection of 0.5 per cent of Northern GNP. Northern investment demand and GNP fall within the first simulation period, establishing an equilibrium interest rate which is about 0.4 percentage points above the baseline.

[49] See among others Sachs (1988), Dornbusch (1989) and Vos (1991) for critical reference to this 'model-driven' policy optimism.

4. *Global financial instability?*

If large interest rate movements are required to adjust the global macroeconomic balance, capital movements provoking such adjustment may also be a cause of greater financial instability. In terms of the present discussion, the additional demands for concessional finance may enhance the adjustment problem in the North. If not accompanied by adequate fiscal adjustment, the transfers will produce widening fiscal gaps and a further accumulation of public debt. Since private savings do not tend to compensate (fully) for this (see section I), it may become increasingly difficult to reach global macroeconomic equilibrium. Higher interest rates will have a growing impact on fiscal balances, and private sector willingness to hold public liabilities and to invest may be gradually undermined. A Northern financial crisis scenario is not contemplated by the global model systems, but the evidence seems to indicate the world economy may not be far from the edge of one.

Large interest rate adjustments and instability naturally also have a large direct impact on the indebted developing countries. If at the same time, they impact negatively on investment and growth in the North, export markets of the Southern economies will be affected and their ability to service debts and their creditworthiness will be reduced. This could imply for many developing countries a persistence of their debt problems.

In sum, global macroeconomic models suggest that a policy-driven reallocation of global savings towards the developing countries may have undesirable general equilibrium effects for the world economy as a whole. Developing countries may be doubly hit by higher interest rates and falling terms of trade and export earnings. An aid increase accompanied by more expansionary monetary policies does not seem particularly helpful as inflationary pressures yield global recessionary tendencies in the medium run. The key to a more stable global adjustment process seems to lie in adequate fiscal adjustment in the North. Northern Governments should thus trade off increased aid transfers against other government expenditures. Current political debates suggest this is a choice which will not easily be decided in favour of the poor countries. Rather, at the moment, existing aid budgets are already being eroded by reallocations of funds towards Eastern Europe. This is by no means an argument against increased aid transfers to the South. Rather, it is argued that the developing countries are better aided if the full (global) implications of these transfers are being considered as part of the policy choices to be made in the North.

These conclusions stand despite the significant differences in the structures and presumed empirical contents of the global models surveyed. Much more work on global model frameworks seems required. Besides the need to deal with global data discrepancies (see section I), some crucial 'elasticity problems' need to be cleared up, particularly regarding the responsiveness of savings and investment to interest rates and, still, the trade multipliers. Specification of global macroeconomic models should improve, including more developing country and Eastern European country detail. It is also necessary to reassess critically the modelling of the institutional behaviour underlying international capital movements.

V. Concluding remarks

The prospects for an expansion of financial flows to developing countries during the 1990s seem far from good. The outlook for some individual countries may be better than for others, but this has not been the main concern here. This paper has emphasized the global economic dimensions of the issue. Looked at it from this angle the following conclusions may be derived from the issues reviewed in this paper:

- Despite a recovery of savings rates in some industrialized countries, concerns about reduced availability of global savings in the medium run seem justified. Demographic factors predict falling private savings rates in the major economies where also the bulk of world savings is generated. Public savings in the large economies are being eroded by the accumulation of public liabilities. This is also undermining even further the responsiveness of the national savings to adjustments in the global interest rate. The response of private savings to interest rates was assessed to be rather low, while rising interest rates will reduce government savings where public debt is large. The implication for the world economy is that each exogenous shift in the global demand for investment resources, for instance an increase in capital transfers to the developing countries, will require a large interest rate adjustment to restore global capital market equilibrium and will crowd out investment elsewhere.

- Many estimates have been given of the capital requirements of developing countries for the 1990s. The methods used to derive these estimates are limited and look only at partial effects, i.e. the external financing needs required to reach a target growth rate given fixed national savings and capital-output ratios. Leaving these methodological limitations aside, the resulting LDC capital requirement estimates are large enough to have a major impact on the world economy. This implies that proposals to raise capital transfers to developing countries will have to take account of the global repercussion effects. The direct effect of additional capital inflows may be higher investment and growth in the recipient countries, but at the same time these could lead to rising world interest rates which will enhance debt-service burdens and reduce investment demand and growth in the industrialized countries. The latter effect will then spill over to commodity markets and reduce demand for developing country exports.

- An assessment of these effects using global trade and macroeconomic models confirms the importance of these repercussions. If additional capital transfers take the form of official development assistance, the effect is like a fiscal expansion in the industrialized countries. If this fiscal expansion is financed by increasing public debt, the consequences may be severe, even to the extent that what is gained through higher capital inflows, is (more than) offset by a loss of export earnings. The key to a more stable global adjustment process seems to lie in adequate fiscal adjustment in the North. Northern Governments should thus trade off increased aid transfers against other government expenditures.

- The workings of the global capital market do not provide developing countries with easy access. Additional transfers will have to come to a large extent from official sources. For most countries private capital markets are still (or have always been) cut off. The recent growth of foreign direct investment and portfolio investment flows has been restricted to a very small group of the larger and richer developing countries. There are no clear signs that this renewed access to private capital markets will be spread out over a wide group of developing countries in the coming years. At the same time, however, private agents throughout the developing world have accumulated large foreign asset holdings. The mobilization of these funds for domestic development will not be easy. Experience in countries where debt conversion programmes worked to repatriate this 'flight capital' indicates that monies returned only after a sustained period of successful adjustment. External finance required for the process of stabilization and adjustment will have to come from official sources. A major part of the developing world is still caught in this process and, in the light of the previous conclusions, will be dependent on budgetary decisions made by the governments in the industrialized countries.

- A number of global macroeconomic models can be used to assess the direct and indirect effects of enhanced capital transfers to developing countries and to analyse who gains and who loses in this game. Still, developing countries are generally poorly modelled and with little detail about structural differences within the group of LDCs. In the light of the previous conclusions, more elaborate global model(s) seems essential to assist international policy analysis. Much more research will have to be invested in this area to deal with the global data discrepancies (see section I), to clear some crucial 'elasticity issues' (particularly regarding the responsiveness of savings and investment to interest rates and trade multipliers), to provide more developing country and Eastern European country detail and critically to reassess the modelling of the institutional behaviour underlying international capital movements.

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Annex

Table A1.1a
Global Savings and Investment Rates, 1970-90
(percent of GNP)

GNS/GNP (%)	1970-73	1974-77	1978-82	1983-85	1986-90
DEVELOPED	22.93	21.81	21.73	19.70	20.73
G-7	22.58	21.71	21.84	19.47	20.52
USA	18.36	18.01	18.74	15.37	14.12
Japan	36.52	32.47	30.92	30.38	32.58
Germany, F.R.	26.02	21.99	21.35	21.81	24.14
REST OECD	25.17	22.21	20.78	20.92	21.94
OTHER HICs	22.80	23.26	26.10	24.32	22.26
EE6+SU	20.15	19.75	19.07	20.26	17.04
MAJOR OIL EXP.	26.04	47.02	37.42	20.69	18.88
LDCs	17.66	19.68	20.24	19.87	22.44
EMENA	21.85	22.86	24.79	23.76	27.24
SSA	13.44	17.76	13.32	9.81	11.38
LAC	17.60	19.67	18.61	17.10	19.01
SOUTH ASIA	13.22	15.39	17.02	17.18	16.54
CHINA	20.46	20.94	24.12	26.37	26.98
EAST ASIA	19.03	21.15	24.15	24.57	29.27
OFF SHORE BK CTR	21.69	26.53	28.33	30.49	31.23
OTHER, N.E.C.	17.16	13.88	13.32	15.08	12.21
WORLD	21.77	21.86	21.70	19.91	20.60

GDI/GNP (%)	1970-73	1974-77	1978-82	1983-85	1986-90
DEVELOPED	22.64	22.17	22.04	20.21	21.17
G-7	22.21	21.72	21.88	20.01	20.94
USA	18.32	17.81	18.86	17.67	16.87
Japan	35.11	32.20	30.74	27.66	29.81
Germany, F.R.	25.30	20.63	21.51	20.10	20.06
REST OECD	25.08	24.16	22.60	21.25	22.69
OTHER HICs	27.04	28.12	26.61	24.30	19.59
EE6+SU	20.08	20.42	19.05	19.40	16.98
MAJOR OIL EXP.	17.80	22.14	25.02	22.65	17.99
LDCs	18.95	21.84	23.49	21.12	23.04
EMENA	22.22	27.50	29.06	26.20	27.99
SSA	15.70	19.26	18.43	12.21	15.26
LAC	19.64	22.53	23.10	17.70	20.15
SOUTH ASIA	14.34	15.91	18.79	19.26	19.28
CHINA	20.45	21.01	23.40	26.93	28.25
EAST ASIA	20.67	23.68	27.25	25.71	25.91
OFF SHORE BK CTRS	26.73	27.32	32.90	29.07	26.41
OTHER, N.E.C.	19.66	16.38	16.67	14.61	13.75
WORLD	21.68	21.97	22.11	20.43	20.99

(Table A1.1a, continued...)

(S-I)/GNP (%)	**1970-73**	**1974-77**	**1978-82**	**1983-85**	**1986-90**
DEVELOPED	0.28	-0.37	-0.32	-0.51	-0.44
G-7	0.36	0.00	-0.04	-0.53	-0.42
USA	0.04	0.19	-0.12	-2.30	-2.75
Japan	1.41	0.27	0.17	2.72	2.77
Germany, F.R.	0.72	1.36	-0.16	1.70	4.08
REST OECD	0.09	-1.95	-1.82	-0.33	-0.75
OTHER HICs	-4.23	-4.86	-0.51	0.02	2.67
EE6+SU	0.08	-0.67	0.02	0.86	0.06
MAJOR OIL EXP.	8.24	24.88	12.40	-1.95	0.89
LDCs	-1.29	-2.16	-3.25	-1.25	-0.60
EMENA	-0.37	-4.65	-4.27	-2.44	-0.75
SSA	-2.26	-1.50	-5.11	-2.39	-3.89
LAC	-2.04	-2.86	-4.50	-0.60	-1.14
SOUTH ASIA	-1.12	-0.53	-1.77	-2.08	-2.74
CHINA	0.01	-0.06	0.71	-0.56	-1.27
EAST ASIA	-1.65	-2.54	-3.10	-1.14	3.35
OFF SHORE BK CTRS	-5.04	-0.79	-4.57	1.41	4.82
OTHER, N.E.C.	-2.50	-2.50	-3.35	0.47	-1.54
WORLD	0.09	-0.11	-0.41	-0.53	-0.39

Source: World Bank data. Ratios derived from current US dollar values.

Notes: GNS (S) = Gross National Savings (= Current Account Balance plus GDI)
GDI (I) = Gross Domestic Investment.
S-I = GNS - GDI = CAB.

Other HICs = Other High-Income Countries (includes Israel, South Africa).
Major Oil Exp.= Major oil exporters of Middle East and North Africa.
EE6 & SU = Eastern Europe (Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Romania) and former Soviet Union.
EMENA = LDCs in Europe, Middle East (excl. MOE) and North Africa.
SSA = Sub-Sahara Africa.
LAC = Latin America and Caribbean.
Off-shore bk. = Off-shore banking centres (includes Hong Kong, Bahamas, Bahrain, Bermuda, Cayman Islands, Lebanon, Liberia, Netherlands Antilles, Panama, Singapore, Vanuatu, West Indies).

Table A1.1b
Private Savings and Investment Rates, 1970-90.
(percent of GNP)

GNSp/GNP	**1970-73**	**1974-77**	**1978-82**	**1983-85**	**1986-90**
DEVELOPED	19.39	20.29	20.95	20.39	19.62
G-7	19.32	20.56	21.04	20.14	19.38
USA	16.72	17.92	18.20	17.20	14.95
Japan	26.45	25.99	25.79	24.97	24.58
Germany, F.R.	21.57	21.49	21.06	21.24	23.52
REST OECD	19.74	19.05	20.63	21.95	21.05
OTHER HIC	20.19	17.89	19.65	22.06	20.74
EE6+SU	3.48	2.89	3.57	3.93	7.70
MAJOR OIL EXP.	12.85	18.20	10.65	6.65	7.41
LDCs	10.28	11.56	11.20	12.77	17.55
EMENA	11.35	11.46	12.86	13.57	17.64
SSA	8.44	13.17	4.10	7.44	11.24
LAC	13.78	13.80	12.73	16.49	23.07
SOUTH ASIA	10.37	12.98	14.34	14.82	16.21
CHINA	2.08	0.82	2.35	-0.18	-0.64
EAST ASIA	15.47	15.37	17.49	18.02	24.44
OFF SHORE BK CTRS	17.71	19.87	20.14	22.62	24.54
OTHER, N.E.C.	11.79	10.06	8.93	12.95	10.19
WORLD	15.51	16.54	17.12	17.06	18.01

GDIp/GNP	**1970-73**	**1974-77**	**1978-82**	**1983-85**	**1986-90**
DEVELOPED	18.78	18.35	18.45	17.17	18.05
G-7	18.54	18.06	18.38	17.08	17.87
USA	16.06	15.86	17.25	16.20	15.32
Japan	26.04	23.21	21.22	20.08	23.14
Germany, F.R.	21.03	16.95	18.22	17.70	18.05
REST OECD	20.64	20.08	19.05	17.93	19.51
OTHER HIC	15.30	15.78	15.58	15.33	13.13
EE6+SU	1.07	1.24	1.10	1.13	0.79
MAJOR OIL EXP.	5.19	6.73	9.50	8.13	5.26
LDCs	8.87	10.55	10.96	9.59	12.22
EMENA	10.30	12.71	13.89	13.00	16.58
SSA	7.34	9.52	8.57	5.54	7.39
LAC	12.82	13.44	12.95	10.54	13.63
SOUTH ASIA	8.15	8.62	9.49	9.16	9.58
CHINA	0.00	0.00	0.00	0.00	0.00
EAST ASIA	14.45	15.87	17.67	16.81	19.37
OFF SHORE BK CTRS	21.99	20.51	25.42	20.96	21.40
OTHER, N.E.C.	11.79	11.62	10.95	10.38	10.06
WORLD	14.45	14.68	14.69	14.66	14.59

(Table A1.1b, continued ....)

(S_p-I_p)/GNP	1970-73	1974-77	1978-82	1983-85	1986-90
DEVELOPED	0.61	1.94	2.50	3.21	1.57
G-7 (1-7)	0.78	2.50	2.65	3.05	1.51
USA	0.66	2.06	0.95	1.00	-0.37
Japan	0.41	2.77	4.57	4.88	1.44
Germany, F.R.	0.54	4.54	2.85	3.53	5.47
REST OECD	-0.90	-1.03	1.57	4.02	1.55
OTHER HICs	4.88	2.11	4.07	6.73	7.61
EE6+SU	2.41	1.64	2.47	2.80	6.92
MAJOR OIL EXP.	7.66	11.47	1.15	-1.48	2.15
LDCs	1.42	1.01	0.23	3.18	5.33
EMENA	1.05	-1.25	-1.03	0.57	1.06
SSA	1.10	3.64	-4.48	1.90	3.85
LAC	0.96	0.37	-0.22	5.95	9.45
SOUTH ASIA	2.23	4.37	4.85	5.65	6.63
CHINA	2.08	0.82	2.35	-0.18	-0.64
EAST ASIA	1.02	-0.51	-0.19	1.22	5.07
OFF SHORE BK CTRS.	-4.28	-0.65	-5.28	1.66	3.14
OTHER, N.E.C.	0.00	0.00	-0.84	3.01	0.96
WORLD	1.06	1.95	2.04	2.99	2.56

Source and Notes: See Table A1.1a.

Table A1.1c
Public Savings and Investment Rates, 1970-90.
(percent of GNP)

GNS_g/GNP	1970-73	1974-77	1978-82	1983-85	1986-90
DEVELOPED	3.54	1.52	0.77	-0.68	1.11
G-7 (1-7)	3.26	1.15	0.81	-0.67	1.14
USA	1.63	0.08	0.54	-1.83	-0.83
Japan	10.08	6.48	5.12	5.41	7.99
Germany, F.R.	4.45	0.50	0.28	0.57	0.61
REST OECD	5.43	3.16	0.15	-1.03	0.89
OTHER HICs	2.62	5.37	6.45	2.25	1.51
EE6+SU	16.68	16.86	15.50	16.33	9.33
MAJOR OIL EXP.	13.19	28.82	26.77	14.05	11.47
LDCs	7.37	8.11	9.05	7.10	4.88
EMENA	10.50	11.40	11.94	10.20	9.59
SSA	5.00	4.59	9.23	2.37	0.14
LAC	3.82	5.86	5.88	0.61	-4.06
SOUTH ASIA	2.85	2.40	2.68	2.37	0.33
CHINA	18.38	20.12	21.77	26.55	27.62
EAST ASIA	3.56	5.78	6.66	6.54	4.82
OFF SHORE BK CTRS.	3.98	6.66	8.19	7.86	6.69
OTHER, N.E.C.	5.37	3.81	4.39	2.13	2.03
WORLD	6.26	5.27	4.57	2.81	2.65

GDI_g/GNP	1970-73	1974-77	1978-82	1983-85	1986-90
DEVELOPED	3.86	3.95	3.99	3.93	3.82
G-7 (1-7)	3.68	3.78	3.84	3.78	3.66
USA	2.26	1.95	1.61	1.46	1.55
Japan	9.08	8.98	9.52	7.57	6.66
Germany, F.R.	4.27	3.68	3.29	2.40	2.01
REST OECD	4.44	4.36	4.27	4.13	4.09
OTHER HICs	11.73	11.85	12.17	12.24	12.34
EE6+SU	19.01	19.10	18.99	19.13	19.17
MAJOR OIL EXP.	12.61	12.12	12.96	14.24	15.41
LDCs	10.08	10.08	10.45	10.86	11.29
EMENA	11.92	11.80	12.17	13.40	14.80
SSA	8.37	8.67	9.25	9.57	9.74
LAC	6.82	7.06	7.71	8.34	9.09
SOUTH ASIA	6.19	6.18	6.37	6.78	7.30
CHINA	20.45	20.53	20.77	21.01	21.01
EAST ASIA	6.22	6.20	6.66	7.20	7.81
OFF SHORE BK CTRS.	4.74	5.20	5.86	6.23	6.81
OTHER, N.E.C.	7.87	7.70	7.13	6.62	6.31
WORLD	7.23	7.23	7.29	7.34	7.33

(Table A1.1c, continued ....)

(S_g-I_g)/GNP	**1970-73**	**1974-77**	**1978-82**	**1983-85**	**1986-90**
DEVELOPED	-0.32	-2.30	-2.82	-3.72	-2.01
G-7	-0.42	-2.50	-2.69	-3.59	-1.93
USA	-0.63	-1.87	-1.06	-3.30	-2.38
Japan	1.00	-2.50	-4.40	-2.16	1.33
Germany, F.R.	0.18	-3.18	-3.00	-1.83	-1.40
REST OECD	0.99	-0.92	-3.40	-4.35	-2.30
OTHER HICs	-9.12	-6.97	-4.58	-6.72	-4.94
EE6+SU	-2.33	-2.31	-2.45	-1.94	-6.86
MAJOR OIL EXP.	0.58	13.41	11.25	-0.47	-1.27
LDCs	-2.71	-3.18	-3.48	-4.43	-5.93
EMENA	-1.42	-3.40	-3.24	-3.00	-1.81
SSA	-3.36	-5.15	-0.63	-4.29	-7.73
LAC	-3.00	-3.23	-4.28	-6.55	-10.58
SOUTH ASIA	-3.34	-4.89	-6.62	-7.73	-9.37
CHINA	-2.07	-0.89	-1.64	-0.39	-0.62
EAST ASIA	-2.66	-2.03	-2.92	-2.35	-1.72
OFF SHORE	-0.76	-0.15	0.71	-0.25	1.68
OTHER, N.E.C.	-2.50	-2.50	-2.51	-2.54	-2.50
WORLD	-0.97	-2.06	-2.45	-3.52	-2.93

Source and Notes: See Table A1.1a.

Table A1.2
Alternative estimates of additional financial resource requirements in the 1990s.

	annual requirements (bln US$, 1990)	GDP growth target (%)	Projection period
Capital requirements LDCs			
All LDCs			
Fishlow (1987)	180	5.3	1995
Development Committee (1988)			
WIDER (Taylor 1990)	43	1.0	
Sub-Sahara Africa			
Fishlow (1987)	15	3.9	1995
Development Committee (1988)	12	3.4	1992
WIDER (Taylor 1990)	28	4.0	
World Bank (1991)	28	5.0	1991-2000
Asia			
Fishlow (1987)	23	6.2	1995
Development Committee (1988)	19	5.4	1992
WIDER (Taylor 1990)	18	1.0	
Europe, Middle East and North Africa			
Fishlow (1987)			
Development Committee (1988)			
WIDER (Taylor 1990)	8	1.0	
Latin America and Caribbean			
Fishlow (1987)	61	5.4	1995
Development Committee (1988)			
WIDER (Taylor 1990)	36	4.0	
Capital requirements Eastern Europe and CIS			
Collins and Rodrik I (1991)	915	7.0	1991-2001
Collins and Rodrik II (1991)	17		1991-2001
Papadia et al. (1991)	340		1991-2011
IMF (1991b)	90		
Eastern Europe (EE5)			
Collins and Rodrik I (1991)	344	7.0	1991-2001
Collins and Rodrik II (1991)	5		1991-2001
Papadia et al. (1991)	100		1991-2011
CIS			
Collins and Rodrik I (1991)	571	7.0	1991-2001
Collins and Rodrik II (1991)	12		1991-2001
Papadia et al. (1991)	160		1991-1996
German Unification			
Papadia et al. (1991)	80		1991-2011
IMF (1991b)	60		1991-1996

Sources: See bibliography.

Explanatory notes:

Capital requirements of LDCs:
- Fishlow (1987) estimations: Based on two-gap model for estimating capital inflow requirements at fixed national savings rates and capital-output coefficients and for pre-set growth targets as indicated in second column.
- Development Committee estimations: Similar methodology as Fishlow (1987).
- WIDER-Taylor estimates: based on three-gap model and extrapolated country group data from 18 individual country models. Base projections simulate capital requirements for 1 percent production capacity increase. data for Sub-Sahara Africa and Latin America presented in the table are a multiple of the estimates presented in Taylor (1990) on the assumption that a 'needs' scenario for these regions would require an expansion of growth capacity of about 4 percent to yield per capita income growth rates of about 1.5 percent.
- World Bank (1991): Based on current account projections with assumption for export growth, import elasticities, projected debt service burden and debt relief.

(Table A1.2, continued ...)

Capital requirements for Eastern Europe and CIS:

- Collins and Rodrik I (1991): Estimations based on real GNP growth of 7.0 percent per year. Assumptions: fixed capital-output ratio of 2.5. Collins and Rodrik assume rather unrealistically that all annual accumulation is to be financed through external capital inflows. In Table 2 of the text these estimates of Collins and Rodrik were corrected for a projected national savings availability in the EE6 and CIS based (possibly optimistically) on constant 1990 savings rates.
- Collins and Rodrik II (1991): Estimations based on Marshall Plan type aid programme for EE6 and CIS. Marshall plan aid flows were scaled to present day values using various alternatives. The one presented here follows a procedure also applied by a study of the Economic Commission for Europe, by which the real per capita transfer is kept the same as that received by the western European countries after World War II. This leads to Collins-Rodrik's lower bound estimate of capital requirements for Eastern Europe.
- Papadia et al. (1991): Estimations over 20 year adjustment period targetting that ex-GDR reaches per capita income level close to that of the western part of Germany, while the EE5 (Bulgaria, Czechoslovakia, Hungary, Poland, Romania) and the CIS reach per capita income levels at level of average of low- to middle-income countries of the European Community. Method is based on existing labour productivity, capital-output ratios, Cobb-Douglas production function characteristics, and constant national savings rates.
- IMF (1991b): Estimation for German Unification based on Masson and Meredith (1990) using similar approach as in Papadia et al., but assuming rising labour productivity to about 80 percent of its level in west Germany. Estimates for CIS not based on any particular method, but taken to be a meaningful number "for illustrative purposes".

Table A1.3

WORLD ACCOUNTING MATRIX (WAM), 1985

(Current prices, values in billions of US$)

		US 1	Japan 2	EC 3	OOECD 4	CMEA 5	MOE 6	OB 7	DB 8	PB 9	ROW 10	MULTI 11	US 12	Japan 13	EC 14	OOECD 15	CMEA 16	MOE 17	OB 18	DB 19	PB 20	ROW 21	MULTI 22	CP 23	CG 24	RESERV 25	Total
US	1	0.0	43.0	90.2	93.3	4.3	11.4	16.9	19.0	61.7	24.1	1.0	652.4											2629.7	816.0		4462.9
Japan	2	84.0	0.0	30.4	17.3	4.0	13.0	13.0	25.5	24.5	14.4	0.6		376.1										774.2	128.9		1506.1
EC	3	102.6	16.7	555.3	129.4	31.0	51.9	33.0	26.8	54.8	19.6	2.3			479.6									1531.3	483.5		3518.1
OOECD	4	118.3	18.7	87.1	25.9	11.3	6.6	9.2	7.5	13.7	6.3	1.0				207.5								523.4	178.8		1215.3
CMEA	5	2.4	2.0	35.7	12.9	119.1	3.4	14.5	5.5	3.2	2.2	0.1					195.6							480.2	74.6		951.5
MOE	6	7.4	28.8	43.2	3.0	2.1	8.4	13.1	7.5	20.1	5.1	0.0						102.4						186.7	121.5		545.2
OB	7	21.9	7.4	31.8	6.0	13.0	13.1	8.1	2.3	6.0	2.5	6.1							89.3					276.3	54.7		538.6
DB	8	13.5	23.3	15.5	3.8	4.1	7.1	6.5	2.2	9.8	9.8	2.0								177.7				346.8	60.1		682.1
PB	9	77.9	21.1	53.1	10.6	4.8	7.6	16.5	9.7	26.3	7.6	1.3									170.4			597.6	98.5		1102.7
ROW	10	35.0	8.0	17.4	6.2	6.5	2.4	3.8	7.0	4.6	4.1	3.4										50.9		104.2	27.0		280.7
MULTI	11	2.9	1.0	6.0	3.0	0.0	0.0	1.0	1.6	2.2	0.0	0.0											0.0	0.0			17.7
US	12	551.3											0.0	40.7	55.1	12.3	0.0	9.5	-2.2	2.1	12.2	0.0	-0.0				681.0
Japan	13		435.1										2.1	0.0	50.2	1.4	0.0	0.0	0.0	0.0	0.1	0.4	0.0				489.4
EC	14			537.5									7.9	41.8	96.9	27.8	1.3	-0.4	0.0	0.0	0.2	0.5	-0.0				713.5
OOECD	15				201.7								3.7	18.0	23.5	1.5	-0.0	2.4	0.0	0.6	0.1	0.4	-0.0				251.9
CMEA	16					196.6							-1.4	0.6	1.9	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0				198.1
MOE	17						113.9						-0.3	2.2	-0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0				115.9
OB	18							72.0					1.9	2.6	4.6	0.2	0.6	0.5	0.0	0.0	0.0	0.0	4.5				87.0
DB	19								160.4				2.3	5.7	2.4	-0.9	-0.0	0.3	0.0	0.1	0.0	0.0	4.1				174.4
PB	20									179.8			7.9	-0.1	-2.9	-2.4	-0.2	-0.5	0.0	0.0	0.0	0.0	2.9				184.7
ROW	21										53.6		0.2	0.1	-1.4	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0				52.0
MULTI	22											0.0	2.5	1.5	5.0	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0				11.5
Priv.Cons.	23	2629.7	774.2	1531.3	523.4	480.2	186.7	276.3	346.8	597.6	104.2	0.0															7450.5
Govt.Cons.	24	816.0	128.9	483.5	178.8	74.6	121.5	54.7	60.1	98.5	27.0																2043.5
Reserves	25												1.8	0.2	-1.4	1.7	1.1	1.6	-0.2	-6.1	1.6	-0.3	0.0				0.0
Total		4462.9	1506.1	3518.0	1215.3	951.5	545.2	538.6	682.1	1102.7	280.7	17.7	681.0	489.4	713.5	251.9	198.1	115.9	87.0	174.4	184.7	52.0	11.5	7450.5	2043.5	0.0	27274.3

Note:

EC	=	European Community
OOECD	=	Other OECD
CMEA	=	Formerly centrally planned countries of Eastern Europe and USSR
MOE	=	Major oil exporters (in North Afria and Middle-East)
OB	=	LDC-OB, 'Official borrowers'
DB	=	LDC-DB, 'Dviersified borrowers'
PB	=	LDC-PB, 'Private borrowers'
ROW	=	Other countries, n.o.c.
MULTI	=	Multilateral institutions

Other accounts:

RESERV = Change in reserves

Table A1.4

GLOBAL MACROECONOMIC MODELS: MULTIPLIERS US FISCAL POLICY

	Year 1				Year 5			
	MSG2	MULTIMOD	OTHER		MSG2	MULTIMOD	OTHER	
			Mean	S.D.			Mean	S.D.
United States								
GNP	0.56	0.80	1.40	0.31	0.06	-0.40	0.64	0.35
Private investment	-0.09	-0.11			-0.23	-0.16		
Private savings	0.40	0.29			0.38	0.12		
Budget deficit	0.79	0.60			0.94	0.30		
Current account	-0.39	-0.10	-0.24	0.10	-0.33	-0.26	-0.44	0.21
Inflation (%)	-0.11	0.30	0.15	0.14	0.15	0.80	0.64	n.a.
Real interest rate (%)	1.16	0.30	0.53	0.22	1.36	0.30	0.84	0.48
Japan								
GNP	0.18	0.10	0.39	0.15	-0.05	0.10	0.69	0.61
Private investment	-0.18	-0.05			-0.31	-0.07		
Private savings	0.22	0.05			0.00	0.13		
Budget deficit	-0.03	0.0			0.05	0.0		
Current account	0.43	0.10			0.26	0.20		
Inflation (%)	0.27	0.10	0.11	0.14	0.07	0.30	0.34	n.a.
Real interest rate (%)	1.02	0.20	0.15	0.28	1.31	0.10	0.20	0.22
Germany								
GNP	0.21	0.10	0.22	0.11	-0.14	0.20	0.36	0.29
Private investment	-0.16	-0.05			-0.31	-0.07		
Private savings	0.15	0.05			0.05	0.23		
Budget deficit	-0.05	0.0			0.07	0.0		
Current account	0.37	0.10			0.19	0.30		
Inflation (%)	0.26	0.10	0.16	0.13	0.12	0.30	0.34	n.a.
Real interest rate (%)	0.96	0.10	0.09	0.10	1.25	0.10	0.26	0.26
ROECD								
GNP	0.17	0.10	0.24	0.09	-0.15	-0.0	0.44	0.26
Private investment	-0.16	-0.06			-0.30	-0.07		
Private savings	0.20	0.04			0.03	0.03		
Budget deficit	-0.04	0.0			0.08	-0.0		
Current account	0.40	0.10			0.22	0.10		
Inflation (%)	0.24	0.10	0.14	0.12	0.10	0.30	0.37	n.a.
Real interest rate (%)	0.97	0.10	0.02	0.02	1.28	0.10	0.22	0.27
LDCs								
GDP	n.a.	0.2			n.a.	-0.0		
Current account	0.10[1]	0.4			0.20[1]	-0.0		
Terms of trade (%)	-2.83	0.3			-2.06	-0.2		

Source: McKibbin and Sachs (1991); Masson, Symanski and Tyron (1989) and Masson and Helliwell (1990).

Notes: All values represent deviations from baseline as a percent of GNP, unless stated otherwise. 1. Percent of US GNP.

THE WORLD BANK AND THE ENVIRONMENT: THE WORLD DEVELOPMENT REPORT 1992

Lance Taylor

Introduction

"Think globally, act locally" is an environmentalists' maxim that the World Bank has unexpectedly taken to heart. Although not green, the ideas underlying the *World Development Report 1992: Development and the Environment* at least tend toward earth colors; the Bank may be seriously beginning to reflect upon the economic and physical milieu of its borrowing constituency. Moreover, like the 1990 edition on poverty, the latest *World Development Report 1992* (here after called *WDR*) represents a step away from neoliberalism and back toward the Bank's attitude of the 1960s: that the continuing existence of the poor in poor nations is the development problem. Indeed, the *WDR*'s insistence on remedying water and air pollution resembles nothing more strongly than 20-year-old strategies aimed at satisfying developing countries' basic needs.

Despite these favourable signs, there is tension in the document between concern over poor people's water, air, and quality of life, on the one hand, and advocacy of a "market friendly" policy line, on the other. Market-friendliness dominated the 1991 *WDR*, which stressed the virtues of price reform and criticized most market interventions by the State.[1] With regard to environmental concerns, this approach mimics the economics mainstream. In the words of a recent, comprehensive review, "As we move into the 1990s the general political and policy setting is one that is genuinely receptive to market approaches to solving our social problems ... the prevailing atmosphere is a conservative one with a strong disposition toward the use of market incentives ..." (Cropper and Oates, 1992). Whether the market alone is capable of dealing with the two major problems of the post-cold war world - the abysmal standards of living of (by the Bank's estimates) one-fifth of humankind and the rapidly deteriorating global environment with its non-negligible possibility of collapse - is a question that the *WDR* cannot quite bring itself to confront.

The discussion that follows, departs somewhat from the *WDR*'s order of presentation by first taking up questions regarding the robustness of market-based environmental policies (which, to be fair, the *WDR* does not fully endorse) and their institutional and political complications (*WDR*, chapters 1, 3, and 4). Next poverty and population growth are treated (chapter 1), then local and national environmental concerns (chapters 2, 5, 6, and 7). Global environmental and economic issues (chapters 8 and 9) are the final topics, addressed from the viewpoint of (possibly) sustainable growth.

I. The environment, the market and the state

The *WDR*'s treatment of the bases for environmental action is its weakest point. Imprecision on the part of its authors is not surprising; after all, no single person or institution is truly equipped to deal with the huge range of ill-understood problems that nature and culture present. But the *WDR* lacks breadth; despite 500-odd references, the range of opinion it canvasses is slight. One looks in vain for citations to persons such as John Sununu, Julian Simon, Jean Dreze and Amartya Sen, Lester Brown, Gretchen Daily, Paul Erlich, David

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[1] For a summary and critique of the 1991 *World Development Report* (*WDR*), see Fanelli, Frenkel, and Taylor (1992). It views public interventions apart from provision of education, some infrastructure, macroeconomic stability, and the "rules of the game" quite dimly.

Pimentel and George Washington Hayduke.[2] Like any document written by a committee seeking a middle ground that will please its superiors, *WDR* leaves out interesting, controversial points.

As each succeeding *World Development Report* documents, the World Bank's management is ideologically committed to the market; this fact no doubt induced the authors to follow economistic lines. They invoke ecologists and anthropologists, but in the final analysis seem not to take seriously their insistence on the need to preserve and sustain diverse natural and human systems as being both sufficient unto themselves and irreplaceable components of an unfolding global dynamics. Nor does the *WDR* fully recognize that change is constrained by history; in natural terms, by existing ecosystems and gene pools, and in human ones, by the institutions that societies maintain. Despite deploring poverty and recognizing factors such as the "deeper spiritual importance" (p. 57) and "amenity values" of forests and other natural phenomena, the *WDR*'s main thrust is that policy should be decided on the basis of environmental benefits and costs.

Even within this market sphere, the *WDR* could probe deeper into the practical efficacy of different policy lines. According to standard theory dating back to Pigou (1918), pollution taxes are an effective means to control environmental costs. The optimal levy on a polluter's activity is equal to its marginal social damage, at a general equilibrium in which all microeconomic "marginal this = marginal that" conditions are in force. Cropper and Oates (1992) give the details along with the observation that if a pollutee can undertake "defensive activities" against a polluter's incursions, then s/he can be counted upon to do so at an "optimal" level without any help from the State.

But can individuals really "defend" themselves against environmental degradation? Cropper and Oates' conclusion recalls Bertrand Russell's (1945) description of utilitarian economics: "'Free competition,' in orthodox economics, is a very artificial conception, hedged in by legal restrictions. You may undersell a competitor, but you must not murder him ... Those who have not the good fortune to possess capital must not seek to improve their lot by revolution".

Ineffective defensive activities were all that the existing legal system could allow the poor families which used to fish the coral reefs around Palawan Island in the Philippines before they were killed by an influx of eroded soil after the forest cover was denuded by land developers and large, profitable logging companies with close ties to the national government (Broad and Cavanaugh, 1989; *WDR*, p. 49). Alternatively, the villagers may have brought their problems upon themselves by non-optimal overfishing as traditional regulation of the coral "commons" broke down owing to pressures from the market and population growth.

Either way, this example of dying "fish homes" (the Filipino word for coral reefs) suggests that optimal tax rules may not be so easy to apply: especially for the poor, the shapes of the relevant response curves are at best known in highly uncertain fashion; moreover, the State may not be politically free to act (timber barons were pretty good at holding putative regulators in check in the post-Marcos Philippines). Unstable prices as planners fine-tune pollution levies, can be economically disruptive - the market will be unhappy if regulators keep adjusting and readjusting taxes on polluters until either environmental standards or "optimal" equilibrium conditions are met.

Weitzman (1974) tried to cut through this veil of ignorance two decades ago, in response to theoretical suggestions that decentralized planning via price signals might well converge to a social optimum but only after many confusing revisions. As is often the case with good neoclassical economics, Weitzman's theorem embodies common sense: quantity regulation is appropriate when its marginal benefits in reducing damages rise sharply but its marginal costs do not. Inability to control adequately toxic substances via charges on their emission can create high social costs; hence, one should opt for quantitative regulation. Contrariwise, excessive burdens may be imposed on both polluters and society as a whole if marginal benefits from excessively stringent controls are constant but their marginal costs rise at a rapid rate - price-based instruments make more sense under such conditions.

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[2] When he was Presidential advisor, John Sununu's views on the foolishness of attacking environment problems were well covered in the international press, and the following seven scholars will be cited in due course. "Hayduke lives" is the rallying cry of the (sometimes) eco-terrorist Earth First movement. G.W. Hayduke led the original monkey wrench gang in their attacks on environmentally unfriendly capitalists and machines (Abbey, 1975).

Besides adopting Weitzman's distinction between policies which act "... by stipulating standards and regulations (command-and-control policies) or by pricing additional pollution or additional resource use ..." (page 73), the *WDR* adds a few other classifications. First, it separates direct and indirect approaches. The former "... target proxies for environmental damage, such as industrial emissions or timber extraction ..." while the latter "... influence actions only indirectly related to environmental damage, such as the use of leaded gasoline or land" (p. 78). Secondly, the State may act directly to influence choice of technology (with all instruments at its disposal, including public investment). Thirdly, it can try to revise property rights such as land tenure laws and customs to influence environmental outcomes and, finally, it should recognize that interventions such as trade quotas and energy subsidies have repercussions on nature and society via the market.

II. Environmental policies in practice

Chapters 3 and 4 of the *WDR* set out these policy characteristics, and present examples - their general thrust is in favour of market-based incentives but caveats are provided as well. Without going through the lists in detail, a few observations can be made:

(a) One fundamental issue has to do with the environmental implications of new investments; after all, the World Bank is in the business of project lending. The *WDR* recognizes that "... numerous public investments - often supported by development agencies, including the World Bank - have caused damage by failing to take environmental considerations into account or to judge the magnitude of the impacts. Indonesia's transmigration program, Sri Lanka's Mahaweli scheme, and Brazil's Polonoreste projects are examples of large programs that caused unanticipated damage in earlier years" (pp. 13-14). More recently, the Bank used independent evaluators to reassess its Narmada River Basin project in India, and agreed to finance resettlement and rehabilitation of the people adversely affected (*World Bank News*, 25 June, 1992).

The *WDR* argues that sharing information with local residents and applying appropriate cost-benefit analysis procedures can avoid such difficulties. It also recognizes that "... equally important are design issues relating to individual project components - road alignments, the design of water systems, and provision of access to forests and wetlands" (p. 14). Social and environmental awareness is required to address such questions; beyond setting general cost and pricing limits, it is not obvious that market forces have much of a role to play.

(b) There are also complications with the cost-benefit calculus itself. As discussed below (section 4), economists like to think macroeconomically in terms of steadily growing supplies of all commodities. But suppose a good such as "the environment" either will be in increasingly scarce supply or will be a "luxury" with steadily rising demand as income grows (details in section 7) - either way its market and/or socially relevant "shadow" price will go up in comparison to prices of other commodities.

Under such circumstances, with environmental goods becoming relatively more valuable, the theory of externalities discussed above suggests that pollution levies should rise over time. Conversely, investments which create environmental amenities in the future should be favoured now. The World Bank and similar agencies should evaluate environmental projects with low (and perhaps declining) discount rates since their future values as seen from today will fall less rapidly than those of other goods; in the jargon, their "own" rates of interest in terms of non-environmental goods will be low.[3] The *WDR* (p. 34) argues that environmental projects should not be evaluated with low discount rates. Despite decades of professional awareness of the implications of differing own-rates of interest, the *WDR* does not recognize the force of steady trend in relative prices.

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[3] A commodity's "own" rate of interest measures how rapidly its value will fall in the future, as seen from today; when trends in prices diverge, then so will own-interest rates. The argument in the text follows Keynes (1936, Chap. 17) and Kaldor (1960), who emphasized how trending relative prices make economic evaluations based on a single, constant "real" interest rate meaningless. Weitzman (1992) brings out this point in terms of investment project evaluation when there are externalities, and presents an elasticity-based formula for computing an "environmental" interest

(c) Scarcity values of environmental amenities may well rise, but the effects on resource allocation are likely to be weak. In order to address most practical problems, mixes of new investment and price, quantity, and technology policies will be applied. For example, the *WDR*'s box 3.4 gives a useful description of how technical shifts (engine retrofits, vapour recovery, the use of low-lead gasoline, etc.), vehicle emission standards and inspection, and higher fuel taxes may be able to make a dent on Mexico City's air pollution. The cost curve for cutting emissions is shifted downward by the gasoline tax, but not by very much. Indeed, in several examples highlighted in the *WDR*, price reform appears to be substantially less effective than technical change in improving environmental conditions.[4]

(d) *WDR*'s repeated injunctions to developing countries to cut subsidies on energy and fertilizer and water use (many low price/cost ratios are illustrated in *WDR*, figure 3.2) may therefore not lead to much environmental response. The fiscal improvements that subsidy reductions could bring may be far more important in that they would permit more environment-friendly public investment, as will be discussed shortly (c.f. section 6).

(e) The relatively weak response to price reform implies that "marginal abatement cost" curves for polluting activities are low and fairly flat, which conforms to economic intuition. Environmental protection is in its early days in the developing world. In terms of Weitzman's (1974) model, relatively blunt quantitative controls may be more cost-effective than sophisticated market manipulation, at least until decreasing returns to command-and-control (CAC) efforts begin to kick in. Moreover, the performance record of market-based policies is not extensive. The entire worldwide corps of interventions such as effluent charges, emissions permits, and performance bonds is marshalled in *WDR*'s table 3.1 - its numbers can be counted on two hands. As Cropper and Oates (1992) take pains to point out, several programmes are essentially trial runs and others boil down to stimulating "transactions" about polluting activities within plants or firms.

(f) There is a also a behavioural reason for opting for CAC regulation, which *WDR* does not bring out. It may be effective in changing how people think and not just act (in economists' terms, CAC can influence preferences and technology, not just choice). Both buyers and sellers of cars are now far more concerned with the dangers of emissions in the United States than they were a generation ago - bureaucratically onerous standards played a role in this particular act of consciousness-raising.

(g) CAC interventions can also help keep environment-friendly social structures in place. The *WDR*'s box 4.4, for example, beautifully describes the reverence for nature that permeates many traditional cultures; as the authors fully recognize, one of its attributes is the maintenance of common property resources. The literature is full of examples of how opening local societies to the full rigors of the price system can lead to both economic misery and environmental loss; in many cases, it appears that traditional activities would have been better served by protective barriers than attempts at stimulating markets.[5] Even apart from traditional cultures, the *WDR* rightly emphasizes the importance of community action and local decision-making

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rate as a fraction (perhaps falling over time) of the market rate. Both the WDR and the World Bank's chief economist Lawrence Summers (1992) fail to consider own-interest and Weitzman-style corrections.

[4] See box 3 in the "Overview" on air pollution, box 3.4 on Mexico City's smog, figure 5.6 on water supply and sanitation, figure 6.5 on air pollution from electric power generation, and figure 6.9 on motor vehicle emissions. Table 8.1 is a partial exception in projecting large reductions in carbon dioxide emissions due to cutting subsidies to commercial energy use in Eastern Europe and the former USSR (by 29 per cent as opposed to 11 per cent in developing countries). But it should be recognized that a massive extrapolation from the existing situation is involved.

[5] Just two examples are given. Early on, Feder (1977) described how tax concessions and infrastructure investment led to disenfranchisement of small scale farmers by cattle ranching in the Brazilian Amazon; traditional forest dwellers were made destitute and in some cases simply wiped out. Jodha (1986) documents how common property resources in the Indian state of Rajasthan have been reduced by privatization associated with land reform programmes unaccompanied by public support for required capital formation and social safety nets.

about environmental issues. Such healthy institutions cannot just be fostered by the market, which at its worst will generate ample side payments to ensure that polluting activities take place NIMBY or "not in my backyard."

(h) Observations along similar lines apply in the area of foreign trade. The *WDR* follows the World Bank line in stressing the market-friendly nature of external trade: "Liberalized trade fosters greater efficiency and higher productivity and may ... encour[age] the growth of less-polluting industries and the adoption and diffusion of cleaner technologies" (box 3.1). Although the Bank never admits it, the assertions about efficiency and productivity are controversial; how more free trade will lead to cleaner technologies is not documented fully in the *WDR*.[6]

Indeed, some economic logic points the other way. An internal World Bank memo attributed to chief economist Lawrence Summers and leaked to Greenpeace and the *Economist* (14 February, 1992) even asserted that it is cost-effective to site pollution-intensive industries in low-wage economies where the loss of earnings due to increased mortality and morbidity is small. Moreover, "only the lamentable facts that so much pollution is generated by non-traded industries ... and that the unit transport costs of solid waste are so high prevent world welfare-enhancing trade in air pollution and waste." Prudently, the *WDR*'s box 3.1 takes the opposite tack, asserting that "... developing countries do not compete for foreign investment in 'dirty' industries by lowering their environmental standards."

The problem, of course, is that there are potentially severe conflicts between liberalized trade and environmental standards. Trade restrictions are visible, easy to apply, and can be effective; that is why they have played a big role in the Montreal Protocol, aimed at reducing atmospheric ozone depletion by limiting chlorofluorocarbon (CFC) gas emissions, and in the Convention on International Trade in Endangered Species (CITES) embargo on the ivory trade. They also can give rise to political conflicts in which environmental activists are on strong ground.[7] The basic disagreement is that advocates of liberal trade want maximum limits on the stringency of regulatory standards that individual countries can impose, while the environmental community wants minimums. The Bank can't have it both ways.

(i) Although non-price interventions can be justified in many circumstances, they bring their own problems. One is that they inevitably involve spending, either mandated to the private sector (e.g. motor vehicle emission standards in the United States) or undertaken by the public authorities. There are obvious limits to such actions. The private sector can only be pushed so far while government outlays in much of the developing world are restained by the international conjuncture that developed during the 1980s. Downward trends in primary commodity terms-of-trade,[8] the debt crisis, and the stagnation of overseas development assistance all made foreign resources extremely scarce, especially in Latin American and sub-Saharan Africa.

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[6] The strengths and weaknesses of liberal versus interventionist trade and industrial policies in promoting growth are discussed by Fanelli, Frenkel, and Taylor (1992). They conclude that "... there is room for debate about such questions, unacknowledged by the 1991 *WDR*." The current *WDR*'s example of how free trade helps cut pollution is thermochemical pulping in the paper industry, originally developed in response to United States and European environmental regulation. Adoption elsewhere is said to have been " ... quicker in developing countries with fewer trade restrictions. As late as 1989, not a single pulp producer in Eastern Europe had adopted this technology" (p. 68). In the socialist Europe of the late 1980s, how many factors besides trade regulation were impinging on this investment choice?

[7] Two more examples: A Danish regulation mandating that beer and soft drinks be sold in reusable containers was challenged by the European Community (EC) as an impediment to free trade under the Treaty of Rome. The European Court first ruled against Denmark but then reversed itself and ruled against the EC. A United States ban on imports of tuna caught by the encircling net method (which kills many dolphins) was challenged by Mexico under the GATT code; a panel ruled that the United States law was contrary to GATT's equal treatment provisions. The United States and Mexico have yet to put the case before the full GATT council, partly owing to their ongoing negotiations on free trade but also because (as one American Congressman put it) "dolphins have lots of votes."

[8] In its box 1.4, the 1992 *WDR* recognizes declines in real metals and energy prices (both since the 1970s and over this century), and argues that they signal that natural resources are not imminently in short supply. Box 5.5 in the 1991 *WDR* minimized these price movements and argued that their adverse effects on exporters were small. The two boxes do not directly contradict one another, but they do reveal a temptation of the Bank to read statistics in more than one way.

Fiscal receipts were similarly affected, putting severe restrictions on public outlays including those for the environment. The linked macroeconomic and environmental implications of this "fiscal gap" are taken up quantitatively in section 6.

(j) More generally, there is no consensus on how macroeconomic factors and policy choices interact in determining developing country growth (let alone the effects of growth on the environment). Fanelli, Frenkel, and Taylor (1992) and the authors of country studies collected in Taylor (1993) argue that foreign exchange restrictions on imports and public capital formation held down third world economic performance in the 1980s. By contrast, the 1992 *WDR* insists on the absence of sufficiently market friendly policy as the explanation for poor performance. It draws on the previous year's version in asserting that "... countries with good economic policies had average growth rates fully 2.5 percentage points higher than those with middling and poor policies and nearly 1 percent higher than the average projected growth rate for the 1990s" (p. 174).[9]

Questions about the self-assurance of World Bank economists inevitably arise: Can we really determine the relative extents to which unfavourable circumstances and market unfriendly policies were responsible for slow growth? Which will more strongly block creation of new resources for environmental or anti-poverty programmes? With its penchant for self-citation, the World Bank has a hard time admitting that opinions differ about the answers to these queries.

(k) A final set of uncertainties surrounds the role of the State. The *WDR* continually takes little swipes at public enterprises, which allegedly will not respond to market-oriented environmental policies because of congenitally soft budget constraints. (The accusation is overstated, but even when it does apply, why not employ targeted, direct policies instead?) Inept bureaucrats also come in for the authors' wrath. But the *WDR* also recognizes that no agency besides the State is likely to try to establish local citizen participation in environmental choices, protect the poor, or "close the skills gap" (p. 91). In a field as rife with economic externalities and political conflicts as the environment, there is an obvious need for a public presence, even if it consists of nothing more than market-cum-environment friendly interventions. How the State can be established as a beneficial environmental actor is an issue that the *WDR* does not address.[10]

III. Poverty

The *WDR*'s discussion of poverty underscores sensible points, but tends to be narrow and brief. Macroeconomically, it is far more straightforward than the 1991 *WDR*. There was a negligible reduction in the population share and an 80 million increase in the number of people falling below a poverty line of US$370 annual income per person (1985 purchasing power parity) between 1985 and 1990. The total of poor people in the latter year was over 1.1 billion from a developing country population of 3.8 billion. These depressing recent developments are attributed to slow output growth (due to bad policy or bad luck?); mention is also made of the worsened position of the poorest in China as it embraced market liberalization in the second part of the 1980s (*WDR*, p. 29).

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[9] The word "had" in the quotation is misleading. The numbers come from table 8.1 of the 1991 *WDR* and are based on model simulations by Bank country economists, who arguably have a vested interest in projecting favourable outcomes during the 1990s to the policies that they recommended. The *1991 WDR*'s table 1.5 (apparently put together by central Bank staff) postulates growth rate increments of a few tenths of percent in response to market friendliness. On a similar point, the 1992 *WDR*'s assertion that "Experience has shown that, on average, the effect of domestic policies on long-run growth is about twice as large as the effects attributable to changes in external conditions..." (p. 32) is based on 1991 econometrics subject to considerable doubt (Frenkel, Fanelli, and Taylor, 1992).

[10] In particular, box 4.5 mentions Japan's " ... stringent government regulations and negotiations between industry and communities ..." but fails to acknowledge the all-encompassing economic role of that nation's State.

At the local level, one can scarcely quarrel with the *WDR*'s (and Bertrand Russell's) contention that the poor are not in a position to buy their way out of ecological trouble even if they are furiously optimizing "defensive activities" within their feasible decision space, and would be less likely to run down natural resource endowments to survive in times of crisis if there were adequate social safety nets in place. Their weakness precisely creates room for the State to intervene. But just what is it supposed to do?

Dreze and Sen (1989) provide some guidance with regard to hunger. They agree with the *WDR* in pointing out that the poor lack "entitlements" or claims to the social product. In acute famine situations their purchasing power can be severely squeezed by spiraling prices which act to reduce aggregate demand; a friendly solution to this market failure is to give stricken people cash (say as wages in public works programmes) and let the private sector handle food distribution. Chronic hunger has been attacked best by directly supporting the spending power of the poor, or else by making sure that they participate in the fruit of growth.[11]

Similar logic applies in other spheres as well. As seen above, the *WDR* correctly emphasizes the importance of protecting traditional societies with their (typically) conservationist practices; the *WDR* further argues that the property rights of the poor should be supported in general. But why the market alone (or even supplemented by the State) can be counted upon to ratify such institutional changes is not made clear. Bertrand Russell's pessimism continues to apply: entitlements always flow easily into the hands of those with power in the first place.

IV. Population growth

Population growth is an even more contentious area, around which the *WDR* simply (but perhaps unavoidably) waffles. There are several topics now under intense debate; the Bank's authors do their best not to choose sides.

One set of doubts concerns the apparently straightforward task of making population growth projections. The *WDR* looks at three cases: a base, and variants with slow and rapid fertility declines. In the base run, the steady state population is about 12.5 billion in the middle of the twenty-second century. A rapid fertility decline over the next few decades would lower this figure to 10.1 billion and a slow decline would make it 23 billion. As in any exponential growth process, small shifts in rates of expansion cumulate into big differences in levels. Economic implications of this twist of mathematics will be taken up below.

The differences in fertility reductions between the low and high projections correspond to observations in countries where birth rates have dropped off rapidly (Costa Rica, Thailand) or slowly (Paraguay, Turkey). Which experiences are better predictors of the future is an open question. Perhaps the high fertility scenario will be more relevant if per capita income growth remains slow, postponing a demographic transition to lower birth rates. Such a vicious circle could be underway in sub-Saharan Africa, for example (*WDR*'s box 1.1).

The World Bank's assumptions about mortality are not spelled out in the *WDR*. However the *WDR* population projections may be far too high. The *WDR* tiptoes around the implications of AIDS, although recent, controversial growth forecasts which factor in mortality due to the pandemic suggest that populations may begin to decline in central Africa as early as the year 2002 (*New York Times*, 22 June, 1992). This scenario differs sharply from the *WDR*'s, in which "... the AIDS virus could reduce African population growth rates by as much as 0.5-1.0 percentage points in the early decades of the next century" (*WDR*, p. 26). If high mortality from AIDS spreads beyond Africa (say to Thailand and parts of India), this latest twentieth century tragedy will make all population projections moot. Its implications for destitution and social breakdown are somber at best.

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[11] Of the 10 countries which performed best in reducing under-5 mortality between 1960 and 1985, Chile, Costa Rica, Cuba, China, and Jamaica followed the first "support-led" strategy and Hong Kong, United Arab Emirates, Kuwait, Singapore, and the Republic of Korea the second "growth-mediated" approach. Lacking targeted intervention, some rapid growers such as Oman and Brazil pursued "unaimed opulence" which did not alleviate hunger and deprivation.

Suppose, perhaps optimistically, that population increases proceed more or less as the World Bank foresees. What are the implications for the environment? Here, there is wide divergence in views among experts and professions. To summarize them briefly, the general issues will be dealt with before the specifics.

As noted above (section 2), economists like to think in terms of growth equilibria. That is, a set of parameters can be used to describe macroeconomic balance when the economy is expanding exponentially. "Small" changes in one parameter (say, the population growth rate) can be compensated by little movements in others (say, the saving rate or capital-output ratio) to sustain equilibrium.[12] If the invisible hand works its magic through prices which vary to mediate these adjustments, then so much the better.[13]

The *WDR* adheres to the economists' model, especially in emphasizing the equilibrating role of prices. For example, the reader is informed that the "... reason why some resources - water, forests, and clean air - are under siege while others - metals, minerals, and energy - are not is that scarcity of the latter is reflected in market prices and so the forces of substitution, technical progress, and structural change are strong." (*WDR*, page 9) Other scholars, typically from different disciplines, stress that there are environmental ceilings which ultimately can limit global economic growth. Such neo-Malthusian views have swung in and out of favour since the *Essay on Population* was published 196 years ago. They are at the moment quite influential; moreover, Malthus may at long last be proved right. Four sorts of potential barriers to continued output growth are worth flagging:

(a) According to the *WDR*, " ... apart from small islands and city-states, only Bangladesh, the Republic of Korea, the Netherlands, and the island of Java ... have [population] densities exceeding 400 per square kilometer. By the middle of the next century, however, one-third of the world's population will probably live in countries with these ... densities" (*WDR*, p. 7). The stress on ecosystems in countries which are not amply endowed with water and/or industry could be intense; already severe degradation is taking place in arid and semi-arid areas, e.g. in sub-Saharan Africa. Solutions will require action by both public and private sectors. Even the *WDR* admits that "Markets are ... inadequate for spreading risks in drought-prone regions because so many people are affected at once" (*WDR*, box 1.2).

(b) Besides the problems posed by high population densities *per se*, there are other local and national environmental constraints which are discussed in the following sections. If they begin to bind, then the trade-off between growth in output per head and population increases could become acute. Some problems such as deforestation and associated losses in biodiversity owing to species extinction spill over into the global arena.

(c) Global warming owing to emissions of the "greenhouse gases" (GHGs) - carbon dioxide, methane, CFCs, and nitrous oxide - could severely destabilize ecosystems worldwide as soon as the middle of the next century. Broadly speaking, GHG emissions rise with total GDP, i.e. increases in both income per capita and population. The *WDR* does not mention it, but limiting GHG emissions could set up a political confrontation between poor countries with expanding populations which want to raise their per capita outputs (say, in India and China, by exploiting large national coal reserves with correspondingly high particulate and carbon dioxide emissions) and rich countries with slow population growth but high (though stable) emissions per head. Of course, the rich countries have been responsible for the bulk of GHG (not to mention CFC) production since their industrialization began 200 to 300 years ago.

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[12] The arithmetic of adjustments around growth equilibrium at constant per capita income can be illustrated with a Harrod-Domar equation between output growth to the left of the equal sign and population growth to the right: $(s/k) - \delta = n$, where s is the national saving rate, k is the capital-output ratio, δ is the rate at which the capital stock depreciates, and n is the population growth rate. Suppose initially the numbers take the values $(0.15/3) - 0.02 = 0.03$. Then an increase in n from 0.03 to 0.035 (a big change) can be compensated by an increase in s from 0.15 to 0.165 or a fall in k from 3 to 2.73, both of which are moderate adjustments.

[13] Faith in the ability of the market and society overall to adjust to changing population growth rates characterizes optimists like Simon (1981), who argues that faster increases improve the human condition. In the 1984 *WDR* devoted to population issues, the World Bank took the middling to pessimistic view of the effects of population expansion on output growth which was characteristic of pre-Reaganite Washington orthodoxy; since then, its statements prior to the 1992 *WDR* have tended to move in the optimistic direction.

(d) As Malthus feared long ago, food supply could become scarce. The *WDR* rightly points out (*WDR*, figure 7.1) that world cereal production almost doubled from 1.0 billion to 1.9 billion tons between 1965 and 1990, owing to an increase of a few per cent in cropped area and a big expansion in yields per hectare. Can output rise further to 3.6 billion tons by 2030 to meet the Bank's baseline population growth projection?

Even ignoring the (largely unknown) implications of global warming, the answer will depend on limiting factors affecting agriculture in different parts of the developing world, e.g. (i) the absence of unused land in South and East Asia and the Middle East; (ii) an increasing scarcity everywhere of suitable sites for new irrigation projects along with rising investment costs; (iii) non-agricultural demands for land and water; (iv) competition of non-staple crops, animals, and export crops for resources which could be used to produce basic foods; (v) no real research breakthroughs in raising yields for coarse grains and roots and tubers like the "green revolution" for rice and wheat; and (vi) observed yield decreases for "green revolution" crops in the 1980s owing to new diseases, increasingly pesticide-resistant insects, depletion of soil micronutrients, and waterlogging and salinization associated with irrigation.

Some specialists find the yield trends and other factors just mentioned extremely disquieting.[14] However, the *WDR* believes that "... long-term observation will make possible understanding and management of these problems" (*WDR*, box 7.3). If the *WDR* is correct about sustainable yields for high-intensity agriculture and prospects for conservationist farming and integrated low-intensity operations involving staple foods, forage, forestry, and ruminants (*WDR*, table 7.2 and box 7.1), then doubling food supplies between 1990 and 2030 may well be feasible. But it will certainly be no mean task.

To summarize, if the world's population doubles (with most of the increase occurring in developing countries) over the next 40 years, this factor could be a source of substantial pressure on the environment - especially if output per capita grows steadily as well. The *WDR* follows the majority of economists in working with projection models which preclude strict environmental limits to growth. A question which any serious report should entertain is whether exponential output expansion will cease to be feasible in the decades to come. The implicit view of the World Bank is that this risk is slight. It would be reassuring to know the reasons why.

V. Water, industry, energy, motor vehicles and agriculture

When the *WDR* stops trying to think globally and discusses policy actions locally, it is on firmer ground. Chapter 2 of the *WDR* gives a sympathetic assessment of the environmental problems that poor people in developing countries face - unsafe water, inadequate sanitation, soil depletion, indoor smoke from cooking and heating fires, and outdoor smoke from coal burning - while chapters 5-7 suggest policy solutions. Some are sensible; others suffer from the deficiencies noted in sections 1 and 2 above.

If clean water and sanitation are not adequately provided, the poor (especially children suffering from diarrheal diseases and women who spend immense amounts of time carrying water) bear the brunt of the social costs. The *WDR* presents both urban and rural examples to suggest that families might be willing to pay for improved water supply. At the retail level - with adequate regulation - private companies may be able to hold down delivery costs.

These pieces of evidence, which "... draw heavily on the cumulative experience of the World Bank water sector staff" (*WDR*, p. 180), lead the *WDR* to recommend that water supply should be privatized to the extent possible, despite the fact that "private involvement in the sector is not a panacea and is never simple. In the United Kingdom water privatization is generally considered to be the most complex of all privatizations undertaken" (*WDR*, p. 111). Even if private water delivery (with associated public regulation) was put in place, the Bank has estimated that sustained investment in facilities would still have to rise by about 0.1 per cent of GDP to help "... bring about dramatic increases in access to sanitation and clean water within the next generation" (*WDR*, p. 113).[15]

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[14] See Daily and Ehrlich (1990) and Pimentel (1991). These authors are known for producing pessimistic scenarios. But does that mean the World Bank can rule them irrelevant to the debate?

The corresponding extra investment in sanitation would be of the same magnitude, but privatization of service delivery (especially for treatment and disposal of sewage and solid wastes) may prove less attractive. Successful programmes from Recife and the Orangi squatter settlement outside Karachi are put forward to suggest that community-organized sewage collection schemes can be effectively implemented. This observation is no doubt true, but it also bears noting that Recife's "condominial" collection system has not taken hold elsewhere in Brazil and the Orangi programme is one of several improvements in that settlement organized by Akhter Hameed Khan, a politically well-connected, charismatic leader. In the absence of such a powerhouse, the task of organizing sewerage projects may have to fall back on local cadres of the State.

With regard to air pollution, residents and visitors in such places as Beijing and New Delhi can attest that levels of "suspended particulate matter" (good old soot and dust, or SPM) in their air can be apalling; on bad days, the atmosphere in Mexico City and Bangkok is poisonous with motor vehicle smog.[16] In total, 1.35 billion urban dwellers in developing countries lived in cities with SPM levels exceeding (relatively stringent) World Health Organization norms in the mid-1980s (*WDR*, figure 2.4). About 500,000 premature deaths per year could be averted if SPM concentrations were brought down to levels deemed safer by WHO guidelines. Respiratory ill health, especially among women and children, is also provoked by indoor pollution from cooking and heating with biomass (wood, straw, and dung) and coal - perhaps 400 to 700 million people are exposed to such risks.

The *WDR's* chapter 6 recommendations about how to deal with these problems are a mixed bag. Urban pollution comes from electricity generation, industry, and motor vehicles. Each source has to be dealt with on its own terms. Price reform is emphasized in all cases, but as observed in note 3, the chapter's diagrams suggest that its efficacy in reducing emissions is considerably less than abatement measures - all of which cost real money. The annual investments required for cutting emissions from coal-fired power stations, controlling motor vehicle emissions and switching to unleaded fuels, and reducing emissions, effluents, and wastes from industry would all amount to 0.1 per cent to 0.3 per cent of developing country GDP on a sustained basis.

The *WDR* also points out that new technologies (not just imports of existing industrial country techniques) can play a role in mitigating these pollution problems. It is relatively sanguine about prospects for solar power (*WDR*, pp. 122-123) and recognizes that nuclear power generation is not cheap. Mass production of improved biomass stoves is proposed. The *WDR* stresses that subsidies on some technologies and taxes on others (e.g. on carbon use), as well as substantially increased spending on research and development will be required if these innovations are to fulfil their promise.

Research and development will also be crucial to agriculture, for example, in finding ways to reverse the trend toward lower yields mentioned above as well as to attack soil losses, salinization, and other problems. However, such expenditures stagnated in the 1980s and still concentrate more on commodity programmes than on integrated approaches to the sociocultural riddles that the sector presents. Maintaining common property ownership systems that help assure sustainable resource management by communities (*WDR*, pp. 142-144) is a case in point. Research is needed to generate concrete proposals about how this goal can be assured. Political action may also be required. The *WDR* points out that security of land tenure (either familial or communal) can be essential to reduce poverty and defend the environment, but somehow fails to mention land reform.

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[15] This goal presupposes that overall water supplies will be "adequate." Economics is necessarily involved in defining the term, but with rapidly growing populations absolute water supply limits may begin to bind in arid regions of the Middle East and elsewhere.

[16] Besides damaging respiratory systems, vehicle smog also can lead to high blood levels of lead, contributing to IQ loss in children and hypertension in adults. The problem is endemic in Bangkok, Mexico City, and elsewhere.

Other agriculture-related questions singled out for discussion include management of forests and preservation of diverse habitats and species. Along with global warming, both topics were subject to intense debate at the United Nations Conference on the Environment and Development (UNCED) held in Rio de Janeiro in June 1992.

One major issue in forestry is overcutting in humid, tropical areas. During the past decade or so, Thailand and the Philippines have been logged out, and the State of Sabah in Malaysia will soon follow suit. Economists such as Repetto and Gillis (1988) attribute such boom-and-bust exploitation to two factors - concessions granted to private sector logging companies are valid for only a few years so that they have no incentive to engage in sustainable yield forestry, and log export restrictions imposed in the hope of promoting domestic industry tend to hold down current "stumpage value" (the difference between log prices and logging costs) and thereby the discounted net worth of the standing forest.

To the extent that this analysis is correct, it raises questions about who should capture stumpage value - long-term concessionaires or the State through appropriate regulation of short-term contracts? Either approach could help lead toward sustainable yield forestry, but practical difficulties often arise, e.g. State Governments in Malaysia have awarded profitable short-term concessions with low stumpage fees because they are under-financed from the centre.

More fundamentally, there is a question as to whether "correct" economic incentives will be sufficient to prevent buccaneers from making fast profits - recall that discount rates are supposed to be high in poor economies. If rapid exploitation is the rule - as suggested by several centuries of raw materials' booms under capitalism in both now developed and developing countries - then to the extent possible public control may be required to protect tropical forests.

One reason why the world market may opt for preservation of forests and other endangered ecosystems is biodiversity - there can be substantial pay-offs to development of new pharmaceuticals and other biological products on the basis of chemicals found in nature. The classic example is the isolation in 1954 of two cancer-fighting alkaloids from the rosy periwinkle of Madagascar by Eli Lilly and Co. By the time the patents had run out, Eli Lilly had made hundreds of millions of dollars from these drugs, and Madagascar not one penny (*Science*, 19 June 1992).

This potential conflict between tropical country suppliers and industrial country users of their products underlay the debate about the biodiversity treaty at the United Nations Conference on Environment and Development (UNCED) meeting, which, at the prompting of its biotechnology industry, the United States refused to sign. While the treaty was being discussed, Merck and Co. (another United States drug firm) agreed to pay Costa Rica US$1 million for the right to analyse hundreds of indigenous plant and animal extracts for possible commercial uses, plus an undisclosed royalty on any marketable product. Whether this deal will be market and environment-friendly in Costa Rica remains to be determined. As is often the case when a transnational corporation deals with a developing host country, the price that Merck paid for access may not have been excessively high.

VI. International resource transfers

The environment presents challenges to developing countries and the world in many dimensions - natural, cultural, political, and economic. All aspects were debated at the UNCED Rio meeting, some without sharp resolution (e.g. weak wording in the convention on means to address global warming) and others in conflict (the biodiversity treaty). The volume of resources needed by developing countries to attack their environmental problems was also discussed. The macroeconomic implications are taken up in this section.

The table below gives two sets of estimates of the yearly spending required to reach plausible environmental targets in the reference year 2000 (at which point GDP in the developing world might be a bit more than US$5 trillion in 1990 prices). The first comes from the *WDR*'s figures, as discussed above, and the second from the World Institute for Development

ESTIMATES OF ENVIRONMENTAL RESTORATION COSTS IN THE YEAR 2000

(Billions of 1990 dollars per year)

	World Bank	*WIDER*
Investment in water and sanitation	10	
Reducing emissions from coal-fired power stations	7	
Reducing motor vehicle pollution	10	
Reducing industrial pollution	10-15	
Raising energy efficiency		11
Developing renewable energy		15
Agriculture and forestry programmes	20-25	23
Family planning (including more education for girls, financial incentives, etc.)	8	33
Total	65-75	82

Source: : *World Development Report* 1992, Development and the Environment, table 9.2; Jayawardena (1991).

Economics Research (WIDER) as summarized by Jayawardena (1991).[17] Substantial outlays are obviously involved - an initial difficulty is that their proposed destinations as specified by the *WDR* and WIDER differ in ways that illustrate conflicting priorities in the environmental debate.

The *WDR* targets US$37 to 42 billion to the local and national problems that it emphasizes - water and air pollution, sanitation, and cleaning up industrial emissions, effluents, and wastes. In contrast, WIDER proposes US$11 billion for raising energy efficiency (which partly overlaps with the *WDR's* industrial recommendations) and US$15 billion for putting renewable energy generation in place. Along with family planning and related activities (for which WIDER allocates US$33 billion), renewable energy production is a first world environmentalists' concern. As seen from the North, both population control and renewable energy reduce the risks of global warming in a politically palatable way. Arguably, poor people in the South are more concerned with quality of life as highlighted in the World Bank's spending recommendations (and might not even mind using more energy, regardless of how it is manufactured). Finally, both sources suggest that over US$20 billion per year will be needed to assure agricultural sustainability and output growth.

Without trying to judge the conflicting motivations behind the table, its bottom line is that if both developed and developing countries' environmental priorities for the third world are addressed, then well over US$100 billion in annual outlays might be required in the year 2000 - roughly 2 per cent of developing countries' total GDP and 0.35 per cent of the world's.

This is not a trivial sum, even on the world scale. It bears recollection that the first and second oil shocks, the Volcker interest rate shock around 1980, and the famous American twin deficits five years later all amounted to around 1 per cent of world GDP and made the system ring like a bell. The adverse external shock that poor economies received from falling terms of trade and the debt crisis in the 1980s was about 3 per cent of their GDP, and authors such as Fanelli, Frenkel, and Taylor (1992) (*op. cit.*) argue that it was directly responsible for a "lost decade" of growth in Latin America and sub-Saharan Africa. The renewed capital inflows required to support "socially necessary" output growth rates (Taylor, 1992), plus environmental outlays as advocated by both the World Bank and WIDER in the table above might sum to over 4 per cent of developing country GDP and almost 1 per cent of the global total. Even if such flows did not strongly perturb the system, where could the money come from?

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[17] The WIDER cost estimates are based on in-house research coordinated by Partha Dasgupta and Karl-Göran Mäler and on Lester Brown, *et al.* (1988), with the latter source providing the cost figures for population control (World Institute for Development Economics Research (WIDER)).

A rise in internal third world savings rates by several points of GDP is not likely; nor would the "Keynesian" problem of converting the extra saving into physically and environmentally productive investment be easy to solve. Fiscal questions arise as well, since a substantial environmental effort would be required by a public sector which was almost obliterated in some countries by austerity programmes during the 1980s. Indeed, as emphasized by a new generation of "three gap" models (Taylor, 1993), fiscal, saving, and external restrictions on growth (and by extension, environmental improvement) are indissolubly linked. The private sector certainly has a role to play in ecological and cultural renewal, but as we have observed, it cannot carry the burden alone.

Resources from developed economies are also likely to be in short supply. During the late 1980s, South to North transfers were on the order of US$100 billion per year. These flows slackened somewhat in the early 1990s (and even reversed for some countries owing to direct foreign investment and repatriation of previous capital flight), but any net flow southward still falls well short of the magnitudes required to break the foreign exchange and fiscal bottlenecks to satisfying growth and environmental needs. The industrial countries have pressing internal demands and will try to fill a huge financial gulf in the former socialist economies. Unless their priorities change, they are not likely to open their purses wide for environmental concerns in the third world.

The question of priorities, however, remains unresolved. Historically, "if a single lesson can be drawn from the early history of conservation, it is that States will act to prevent environmental degradation only when their economic interests are shown to be directly threatened" (Grove, 1992). Between developed countries' fear of global warming and the quest for profits from biodiversity - (a potentially handsome economic gain) - it may be that an annual US$100 billion southward flow by the end of the decade will be in place. But the poor economies should keep their fingers crossed.

VII. Conclusions

One interesting exercise in the *WDR* follows Kuznets and Chenery in tying environmental indicators to per capita GDP (figure 4 in the *WDR* Overview). In cross-country statistical averages, the shares of the population without safe water and (urban) sanitation fall steadily to around 20 per cent when national per capita income is about US$2000 (in the World Bank's "upper middle income" range) and continue more slowly downward at higher income levels. In the urban air, SPM declines from a peak of 1200 micrograms per cubic metre to an "acceptable" level of 100 micrograms above an income level of US$10,000. These indicators all suggest that improving the environment is a "luxury" along the lines discussed in section 2.

Other measures, however, seem to point the other way. For example, carbon dioxide emissions per capita are low in poor countries, and commence to rise steeply at upper middle income levels toward the rich country figure of 15 tons per year. This tendency again underlines developing and developed countries' asymmetrical contributions to global warming. If emissions as a function of per capita income stabilize at some level in the future (which apparently will be required to avoid catastrophic warming in the long run), we will have another example of an income-elastic environmental response.

These relationships suggest that countries have different "tastes" and deploy different technologies to deal with environmental problems at diverse income levels. According to the

WDR, the curves have moved downward somewhat over time, "... providing an opportunity for countries to develop in a less damaging manner than was possible earlier" (*WDR*, p. 10). This thought is hopeful, but does not get the environment very far. Given the cost estimates discussed in section 6, major gains will be unlikely in the short to medium run unless public preferences shift in their favour and/or new abatement technologies come onto the scene. The market can support such developments, but they have to be initiated by enlightened public opinion and the State. As an important actor, both economically and in terms of shaping international points of view, the World Bank can play a big role in helping these processes along. Its obsession with market-friendliness notwithstanding, the latest *World Development Report* represents an excellent start.

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ON GRADUALISM, SHOCK TREATMENT AND SEQUENCING

José M. Fanelli and Roberto Frenkel*

Executive Summary

The paper presents a critical assessment of some relevant issues regarding the discussion on shock as opposed to gradualism in the implementation of economic adjustment. Since the discussion of these issues has emerged and developed in the literature on liberalization reforms under the heading of "the problem of sequencing", much of the paper is devoted to analysing such a problem.

The initial proposals of liberalization reforms were based on static arguments regarding the welfare advantages of free markets, and lacked an analysis of the dynamic path of the economy when it moves from a "repressed" setting to a complete elimination of non-market constraints. The lack of a systematic analysis was apparent when it was necessary to account for some failed liberalization attempts in the early 1980s, particularly with regard to the dramatic collapse of the so-called Southern Cone experiments.

The lessons on the sequencing of liberalization which appear in the market-friendly approach literature may be synthesized as follows:

(1) The transitional period is very long and difficult to manage. During this period the role of the State is crucial in designing the speed and attributes of each stage of liberalization, especially regarding trade, the decontrolling of the capital account and the financial system.

(2) The transitional period can be very painful and the Government has to take political constraints into account.

(3) During the transitional period, there will be a reduced availability of credit.

(4) The State has a crucial role to play with regard to the regulation of the economy. The analysis of financial crisis in the Southern Cone of Latin America, the Philippines and Turkey shows that the financial system must be tightly supervized by the authorities including, eventually, credit rationing and the control of interest rates.

This set of lessons was extracted from the analysis of processes of liberalization reform which were implemented in the past. The reforms that are now under way will give rise to several lessons as well. Many LDCs are now taking decisive steps in the direction of market liberalization. Beyond the "optimality" of the market-friendly approach strategy, the hypothesis that the adoption of such a strategy is a consequence of the weaknesses of the State cannot be discarded. The strategy promises to solve simultaneously two fundamental problems of the State: lack of financing; and lack of a clear definition of the State's role in development. The two fundamental problems are not solved but rather by-passed by the Washington Consensus approach. The lengthy transitional period of the liberalization strategy requires an efficient intervention by the State while the launching of the reform per se is unlikely to fulfil the financing needs of the economy.

Is it best to approach the study of the reforms which many countries are de facto implementing by considering them a problem of "sequencing"? This may not be the best strategy from either an economic policy or a theoretical point of view. Instead of beginning from a rather abstract notion of a fully-liberalized economic setting, and examining the supposedly correct sequence of steps needed to reach it without difficulties, it would be more fruitful to examine concrete steps of reform then to analyse the specific dynamics they generate. Room should be made to consider the potential role that government and market failures could play in determining the effects of specific measures.

In addition, the possibility that the dynamic path generated by the reform might be explosive should not be discounted. In the evaluation of the reform experiences, in terms of "correct" or "in-

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correct" sequencing, many authors make a strong a priori assumption: correctly ordered liberalizing reforms always set the economy on a stable path with a significant rate of growth. This assumption has no foundation other than beliefs derived from simplistic models and there are no reasons to exclude a priori the possibility of explosive paths or stagnant equilibria. This is true independently of the order in which reforms are implemented. Such assumptions do not help in understanding the characteristics of real reform processes. It is a fact that many liberalization attempts gave rise to explosive paths which must be accounted for. Obviously, the relevance of this issue is not only analytical.

Introduction

> *"Liberalizing a highly repressed economy has been likened to walking through a minefield: your next step might be your last."*
>
> McKinnon, 1991, page X.

The purpose of this paper is to present a critical assessment of some relevant issues regarding the discussion on shock as opposed to gradualism in the implementation of economic adjustment. Since the discussion of these issues has emerged and developed in the literature on liberalization reforms under the heading of "the problem of sequencing", it is worthwhile making an effort to analyse such a problem.

The initial proposals of liberalization reforms were based on static arguments regarding the welfare advantages of free markets, and lacked an analysis of the dynamic path of the economy when it moves from a "repressed" setting to complete elimination of non-market constraints. The lack of a systematic analysis of the dynamic properties of the model was clearly noted when it was necessary to account for some failed liberalization attempts in the early 1980s. This was particularly so with regard to the dramatic collapse of the so-called Southern Cone experiments. Since the failures were attributed to the order in which the liberalization measures were implemented, the search for a "correct" order of implementation gave rise to the emergence of the issue of sequencing as a more or less delimited area of research inside the liberalization framework. Interest in the issue increased during the 1980s as many LDCs and former socialist countries embarked on structural reform and it was necessary to evaluate the cost and benefits of a gradual versus a shock approach to liberalization.

In this way, the discussion of the dynamic properties of the liberalization framework was motivated by "real world" phenomena rather than by theoretical considerations and, consequently, from the very beginning, the analysis of the "problem of sequencing" was inextricably related to economic policy questions. Hence, account is taken not only of theoretical issues but also of concrete experiences of liberalization in the discussion which follows the dynamic questions posed by structural reform.

The paper is organized in four sections. The first section intends to place the sequencing problem in the literature on liberalization reforms and to identify different aspects of the problem. The second and third sections comprise a critical survey of the sequencing issue organized around the different aspects defined in the first section. Whereas the first three sections mainly focus on a critical assessment of the consistency of the liberalization framework, the fourth section presents an analysis of two experiences of liberalization reforms: Argentina and Chile in the late 1970s. Because these two cases played an important role in the gestation of the issue, reviewing the experiences and contrasting the present analysis with the sequencing approach offers a complementary, applied perspective to the previous sections. The last section includes some conclusions and a suggestion to redefine sequencing as a research issue outside of the liberalization framework.

I. Liberalization and sequencing

The authors who adopt the liberalization approach to development do not doubt that developing countries should rely more on the market mechanism.[1] Edwards (1986) put it in a nutshell when he said that an "impressive body" of empirical evidence indicates that liberalized and export-oriented economies outperform - in terms of both growth and equitable income distribution - repressed and closed economies. Along the same lines, Krueger (1986) wrote "the enormous success of Europe and Japan in expanding output and raising living standards was clearly related to the sustained liberalization of trade and capital flows" (page 15). The long-run steady-state benefits of liberalization stem from the fact that free trade and the absence of disturbances of the market mechanism lead to a maximum degree of allocation efficiency and to the specialization of the economy along the lines of comparative advantage (Michaely, 1986). Other beneficial consequences are that technical efficiency increases via competition while rent-seeking (Krueger, 1974) and directly unproductive profit-seeking activities (Bhagwati, 1982) are eliminated as long as the freeing of markets impedes the creation of artificial scarcities. Balassa (1986) emphasizes that it is necessary to take into account the effects not only on inter- industry specialization but also on intra-industry specialization; improvements in x-efficiency and unused capacity.

The basic diagnosis of the liberalization literature is, then, that instability and stagnation in less developed countries are rooted in the malfunctioning of markets. Although the neoclassical approach recognizes that markets may not work well because of the existence of market failures, on "empirical"[2] grounds this literature tends to assume that this is not generally the case. If market failures exist, the effects are supposed to be negligible. Therefore, liberalization is always welfare-improving.

The assumption is that it is excessive government intervention which explains the failures in the functioning of market structure. Government failure is much more relevant than market failure. According to Lal (1990) policy-induced distortions "have done more damage to Third World prospects than the so-called endogenous distortions in these economies that the policies were meant to cure" (page 268). It follows then that what is needed to overcome macroeconomic instability and to restore the growth process is to eliminate the non-market disturbances induced by Government. Once removed, resources will be optimally allocated according to market signals.

Krueger (1986) provides the following definition of liberalization: "A market is liberalized if there are no quantitative restrictions attempting to control either buyers or sellers, from which it would follow that liberalization is the act of removing quantitative controls" (page 17). However, as Krueger recognizes, given the complexities of the real world, more often than not this definition is too narrow. This is particularly so in the realm of economic policy making, where it would be better to work with a broader definition. Taking this into account, Krueger says that liberalization can be defined "as any policy action which reduces the restrictiveness of controls - either their complete removal or the replacement of a more restrictive set of controls with a less restrictive one. Under this definition, an action such as devaluation, given an import-licensing regime, liberalizes that regime" (page 16).

With these definitions in mind, one could expect the research agenda of the liberalization approach to give a prominent role to the analysis of the dynamic path of the economy when it is moving from a situation of repression of the market forces to the complete elimination of all non-market constraints. One could also expect a no less prominent role for the question of the correct sequencing of liberalization policies. However, this was not the case during the first stages of the theoretical development of this paradigm. Specifically, before the 1980s, much more effort was devoted to examining the "comparative static" properties of the model and to describing the benefits of the post-liberalization situation than to characterizing the properties of the disequilibrium path of the economy between repression and free market.

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[1] Fischer (1987) analyzes the main issues raised by the liberalization literature. See also the bibliography cited there. Fischer (1990) affirms that there are no longer two major competing economic development paradigms because the only paradigm is the market oriented one. This contention, however, has been recently challenged even by neoclasically-oriented writers. Krugman (1992) calls for a counter-counter-revolution in development economics: it "may serve as a caution against carrying a free-market orthodoxy too far" (page 21). Krugman ends the paper saying that "it is probably time once again to focus on market as well as government failures" (page 22).

[2] The quotation marks are due to the fact that there is some contradictory treatment of the issue of the empirical relevance of market failures in this literature. For example, they say that government intervention based on the existence of externalities should be avoided on the grounds that they are very difficult to identify and to quatify. If this is so, how can we be sure of the empirical irrelevance of such externalities?

The relevance given to the discussion of the dynamics of the model had greatly changed during the last decade or so. Specifically, the problem of the correct sequencing of the reforms received considerable attention. However, this new interest was motivated in a rather negative way: it was necessary to find an explanation for the failure of the liberalization attempts in the Southern Cone of Latin America and in countries in other regions as well (for example, the Philippines). One consequence was that the issues related to sequencing were introduced into the liberalization framework in a rather *ad hoc* way. They addressed this question not because of logical necessity for the theory but rather to explain *ex post facto* the economic facts that the theory in great measure had been unable to predict *ex ante*.

In principle, the optimal sequence for implementing a liberalization policy can be defined as that which maximizes the present value of the net addition to the economy (Michaely, 1986). Even though this definition of the optimal sequence seems to be clear, the implementation of such a concept gives rise to many complex theoretical and empirical questions. The first concerns the range of markets that should be taken into account in the analysis. Normally, the authors focus on a narrow set of markets: foreign exchange (including both current and capital transactions), financial, labour, and key domestic goods markets such as agriculture and energy (Krueger, 1983; World Bank, 1987; 1991). The second has to do with the order of the liberalization of each of the markets included in the above-mentioned set. Should all the markets be liberalized simultaneously? Is it better to liberalize in successive steps? If the latter is the optimal decision, what markets should be liberalized first? The third question that arises is that of the speed of the liberalization: How fast should each market be liberalized? Should the liberalization of a single market be made in one stage or is it better to attempt to implement it by means of a multi-stage policy? Closely related to the latter question is the problem of defining the attributes of the stages of the implementation of the reform in individual markets.

So far, the question of sequencing has been presented as one related to the dynamic problems attached to the comparative static theorems of the liberalization approach. However, during the 1980s, there was an enlargement of the set of issues addressed under the heading of "sequencing". The discussion of the questions posed by macroeconomic constraints and by the institutional setting of the reforms has steadily gained relevance.

The introduction of these new topics was mainly due to the fact that during the 1980s, the main policy recommendations of the liberalization literature were adopted as the official policy package by the World Bank and the IMF.[3] The most important potential candidates for the reform were the Latin-American and Sub-Saharan region suffering from the consequences of the debt crisis and the former socialist countries. Consequently, given the extreme macro-instability of these countries and the depth of the needed institutional reforms - which entailed not only the elimination of government intervention but also the restructuring of the State in itself - it was only natural that the liberalization approach should address both the problem of stabilization and that of the reorganization of the public sector. The adaptation of the liberalization approach to the new context of the 1980s gave rise to the so-called Washington Consensus (Williamson, 1990) or "market-friendly approach" to policy reform (World Bank, 1991).

In the most recent work of the Washington Consensus, the stabilization problem was completely integrated into the analysis of the reform (Williamson, 1990; World Bank, 1991). Therefore, it is now implicitly understood how necessary it is to define the order of the sequencing in which the *structural reforms* aimed at freeing domestic markets and the *stabilization policies* should be implemented. In analysing this issue, the liberalization literature has been amended to include the IMF adjustment approach.

The integration of the problems posed by the dynamic interaction between the reform of the public sector (especially privatization) and market liberalization, however, was much more difficult, particularly because there has been a tendency in this literature to by-pass the institutional and historical specificities of the countries under study.[4] In the 1991 *World Development Report*, for example, the economic problems of Bolivia and Poland have been analysed as if they were basically manifestations of the same phenomenon of "repression" of market forces.

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[3] *Strictu sensu*, the question of the order of stabilization vis-à-vis liberalization reforms began to be closely examined after the failure of the stabilization attempts of the early 1980s.

[4] Brutton (1989) stresses the importance of initial conditions, history and the general social environment. According

Indeed, as a consequence of the crisis of the former socialist countries, the production of literature on transition and reform in those countries is flourishing and there is a profuse flow of studies related directly or indirectly to the order in which economic reforms should be implemented.[5] In this literature, the discussion of the order in which markets should be *created* or the ways and velocity in which privatizations should take place overlaps with the issues traditionally treated by the literature on sequencing in developing market economies, which had mainly focused on trade and financial reform.

Although some of the lessons learned from the reforms attempted by less developed countries can undoubtedly be useful in the analysis of transition in former socialist countries, it is far from evident that analogies can be easily traced. This is so, among other reasons, because of the diversity of the institutional settings. It follows that, on an abstract level, the study of the optimal path of the economy and the sequencing of policies from repression to liberalization implies the analysis of the range, order, speed and attributes of each stage of the market-oriented reform, and of the macroeconomic and institutional settings in which such reforms will be implemented as well. These issues will be examined in greater detail below.

II. The problem of sequencing: reforms, short-run rigidities and political constraints

Should all the markets be liberalized at the same time? Which is more likely to succeed: shock treatment or gradual implementation of the reform? On strictly economic or analytical grounds, it seems that there is a consensus on the convenience of adopting a gradual treatment (i.e. sequential) rather than a sudden one. This consensus is not absolute, however. It seems to diverge especially on the analysis of the "political economy" aspects of the reform. Indeed, in this literature, there is a certain tension in the integration of economic policy recommendations based on economic analysis with those stemming from the consideration of political economy factors.

The ambiguities generated by this tension is patent in the treatment of gradualism versus the shock issue in the 1991 *World Development Report (WDR)*, which constitutes one of the most recent and influential policy-oriented works produced by the Washington Consensus. The standard recommendations on the correct order of reforms are clearly mentioned in the context of macroeconomic considerations, but at the same time the *WDR* seems to encourage a simultaneous approach. Indeed, the *WDR* introduces the concept of "shock therapy", exemplified by the mention of Bolivia, Ghana, Mexico and Poland. Most of the arguments in favour of this approach - defined as a quick and concentrated adjustment programme to be developed in a two-year period - rest on political economy considerations. A set of quick simultaneous reforms has the ability, we are told, to prevent the organization of resistant coalitions of interest groups. It should be underlined, on the other hand, that the set of reforms alluded to in the *WDR* is sometimes much broader than the standard trade-finance set, including, among others, labour market institutions, government administration and privatization.

Certainly, this tension between economic analysis and political-economy factors reflects the existence of a deeper tension between the state-of-the-art research on liberalization and sequencing, on the one hand, and the necessities of "practical men", on the other. Specifically, there is a wide knowledge gap between what can be said based on sound theoretical foundations and the amplitude and complexity of the questions posed by the ongoing liberalization efforts. But, while most researchers following the liberalization tradition believe that "more research is needed" especially with regard to the sequencing issue, policy-oriented writers argue in favour of the reform as if political conviction were much more important than the "details" regarding the dynamic behaviour of an economy after the implementation of liberalizing reform. The following section, will review these issues from both an analytical and a "political economy" point of view.

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to Brutton, "the policy-maker is never looking at a blank sheet on which he can put down what an objective, highly competent, but extremely narrow analysis tells him is the right policy. This is especially the case when it comes down to designing a specific policy in a specific country at a specific time" (page 1261).

[5] See Fischer (1992) and the bibliography there cited.

A. The rationale for gradualism and sequencing

Deepak Lal (1990) argues that in order to reap the benefits of liberalization, it is better to induce a complete and simultaneous lifting of all the non-market constraints. The only "if" allowed for in Lal's approach to structural reform is the need to eliminate macroeconomic imbalances first.

It can be said, nonetheless, that beyond particular disagreements -similar to that of Lal's- the vast majority of the economists subscribing to the Washington Consensus therapy are opposed to a simultaneous lifting of all the constraints. Such a majority would presumably agree with Krueger (1986) when she writes that "there is not sufficient experience with the "cold shower" approach to liberalization to provide confidence that its short-term costs can be contained within reasonable bounds ... the experience of Argentina, Chile and Uruguay have further provided support for the skeptics" (page 20).

In more general terms, it is argued that if markets performed their task in a world without imperfections, the best policy would be a simultaneous and complete liberalization of all markets. But the real world is much more complex than is assumed in theory (Edwards and Wijnbergen, 1989).

Even though the authors toiling in the liberalization tradition tend to discard the kind of failures that would call for discriminatory treatment and that could preclude liberalization from being the optimal tool for reaching the maximum degree of welfare (i.e. terms-of-trade effects, economies-of-scales or large externalities), most of them are aware that there are other imperfections in the real world. There are frictions in the functioning of markets and short- run rigidities, asymmetrical income distribution effects, macroeconomic-specific disequilibria and political factors that could have a bearing on the final results of alternative policies.

If, for example, the degree of protection removal from an activity is great, the production is likely to decline because capital goods and labour skills are to some extent specific. Therefore, unemployment may result from policy reform. The more the resources are called to move among widely different activities, the greater the significance of the frictional elements. It is then clear how necessary it is to graduate the liberalization effort (Michaely, 1986). Likewise, regardless of the pressures on unemployment rates, in a specific-factor setting, the larger and the more rapid the changes, the greater the consequences on income distribution will be. Because of unemployment and/or distributional consequences, political feasibility seems to call for an analysis of the cost-and-benefits of sequencing versus shock.

It is because of the existence of the above-mentioned imperfections that the "comparative static" statements of the liberalization approach yields no detailed guidance for the design of policy implementation (Michaely, 1986; Michalopoulos, 1987). Likewise, one could add, when "real world" complexities are taken into account, the statement avering that "from all the dynamic paths available one must be optimal" seems to lose much of its appeal, at least from an empirical point of view. To be of any practical relevance, the dynamic properties of economic policy recommendations need to be carefully evaluated in the light of the existing "real world" constraints.

Many of the economists identified with the "market-friendly approach" recognize that the study of these questions is just in its initial stages. In his analysis of the problem of sequencing, Michaely (1986) concluded that the problems of phasing and sequencing have not yet been addressed even though comprehensive studies of liberalization as a whole are available. Edwards (1986) closes his paper on these issues listing many unsolved questions. Indeed, once the "cold shower" alternative is discarded as not feasible, a whole set of new problems must be faced, problems that are both empirical and theoretical. That is, the question becomes how to analyse the effects of the reform on welfare, on macroeconomic balance, and on income distribution in a disequilibrium context (i.e. during the transition period) when using the analytical tools of the liberalization approach which had been developed to examine the properties of market equilibrium.

B. *The welfare effects of liberalization in a disequilibrium context*

If a single-step liberalization reform is operative, it follows that over a substantial time span, some markets will be working without restrictions while others will still be constrained by non-market factors. The existence of a transitional period of disequilibrium entails severe complications for standard welfare calculations.

The most important of these complications is that the main welfare economics theorems which show that the resource allocation yielded by the market mechanism constitutes a Pareto optimum are no longer valid when non-market constraints impede the simultaneous clearing of all the markets. The existence of distortions in the markets that remain unaffected by the reform implies that the elimination of distortions in another does not necessarily increase welfare. As the generalized theory of the second best states, if relevant links between markets exist and there is a reduction in the magnitude of a distortion in a single market, it is not possible to determine the direction in which welfare will change. In other words, we cannot be sure that the implementation of a specific stage of the liberalization policy will improve society's welfare. For example, starting from a situation characterized by distorted markets, there are no firm bases on which to ascertain that import liberalization will always be beneficial if, say, labour or capital markets are still repressed.

With regard to these issues, theory is blind. "All that can be said is that no general preference for the order of policies may be established on *a priori* grounds. Empirical observations may provide some lessons about the association of such sequencing with the likelihood of success of a policy package" (Michaely, 1986, page 54).

The question of the effects of liberalization is stated on empirical terms precisely because it cannot be proved on theoretical grounds that a hands-off policy is desirable when some markets are not working properly. In this context, the practical question is: when can a market be freed in reasonable confidence that the net effect will be welfare-improving?

Krueger (1986) formulates this question and answers that it is always welfare improving to liberalize the markets, with the exception of the capital account transactions of the balance of payments. But Krueger's arguments with regard to this are based on a rather casual empiricism. In fact, the issue of the welfare effects of deregulation in a disequilibrium context is treated neither rigorously nor systematically in the liberalization literature.

C. *Welfare and income distribution effects*

A second problem regarding the welfare effects of freeing the markets has to do with income distribution. Even if it were assumed that liberalization would result in an overall national welfare gain, there would be sectors that gain and sectors that lose. That is, there would be asymmetries in the distribution of the increases in welfare.

It is rather intriguing in this literature that while the idea that liberalization improves national welfare is supposed to be a matter of course, there is not much effort devoted to analyse how such gains could be managed or distributed. Indeed, with regard to income distribution, most of the analytical effort is directed at analysing how the existing pattern of distribution constitutes an obstacle for market deregulation.

It is argued, typically, that the government tends to behave on the basis of a conservative social welfare function which makes it reluctant to allow big changes in income distribution regardless of who gains and who loses. Likewise, government interventions are conceived of as tending to be dominated by the political process. An endless series of examples are given in order to show how interventionist policies in trade, the financial market, etc, are manipulated in practice by special-interest politics rather than being based on sound national cost-and-benefits calculations. According to many authors, these facts explain why it is so difficult to dismantle the ISI-type policies which were put into practice during the post-war period in many LDCs, particularly in Latin America.[6]

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[6] See, for example, Balassa *et al.*, 1986. The surveys by Krueger (1984) and Balassa (1989) are also particularly relevant to this issue.

Given that the complex structure of the protectionist and interventionist policies has created strong vested interests, it has sometimes been suggested that compensation measures should be used as a kind of bribe to get the losers to agree. In other word, compensation may induce them to accept the changes. But beyond this, regardless of the particular specification of the government's social welfare function, the only universally valid generalization provided by this literature for treating the allocation of welfare gains is methodological: efficiency and income distribution issues should be treated separately. A golden rule of economic policy-making according to the Washington Consensus is that policy-makers should use appropriate non-distortive tools to cope with income distribution matters. For efficiency gains to be attained, it is crucial to avoid inducing additional market distortions by resorting to second best alternatives when there are (usually?) first best policy measures available which are functional in achieving the same objective.

For example, when arguing that even in a disequilibrium context, deregulation of agricultural markets is likely to be welfare-improving, Krueger (1986) said: "I ignore the short-run welfare losses of low-income persons paying higher prices for food on the grounds that superior measures can be found to yield the same real income transfer" (page 24). However, it is very difficult to find in this literature a systematic treatment of such "superior measures" based on sound and informed "empirical observations". And when one does find analytical treatments of these matters, the conclusions are rather disappointing. Examining the issue within the neoclassical framework, Rottenberg (1986) observed that, when a policy change making the use of resources more efficient was implemented, it was practically impossible to compensate the losers without inducing additional disturbances which would run against the increase in efficiency. This is so whether the compensation was implemented via money payments or via complementary policy changes. Rottenberg's conclusion is not encouraging: he compares compensation payments to the opening of a Pandora's box of income and wealth transfers. Sometimes one feels that references to income-distribution-offsetting policies are no more than rhetorical arguments.

D. The ordering of the liberalization attempt

Concern with the order of implementation of market-oriented policies has gained momentum after the failure of many of the liberalization attempts in Latin America and elsewhere. Some ideas about the order of liberalization may be found in McKinnon's (1973) original work, but the concept of sequencing, related to a specific pattern of time phases of structural reforms, has emerged mainly as a reaction to the dramatic failures in the Southern Cone of Latin America. Edwards (1986), who devoted a significant effort to analysing the subject, has called attention to the fact that although the countries followed contrary orders - Argentina and Uruguay opened the capital account first, while Chile opened the current account first - all of them had a common fate: deep economic recession and (partial) reversal of the liberalization attempt. Edwards concludes, "at the present time there are no definite answers regarding these experiences and more research on the subject should be encouraged" (page 208). Likewise, Krueger (1986) considers that "further analysis of the liberalization efforts of the 1970s, especially in cases where domestic and international capital markets were important is called for" (page 30).

The liberalization efforts of the 1970s alluded to by Krueger collapsed in the early 1980s. Between 1980 and 1982 Argentina, Chile, and Uruguay underwent simultaneous external and domestic financial crises after a period of expansion financed by intensive international borrowing. The expansionist period followed liberalizing reforms in the trade regime and the deregulation of domestic and external financial flows. These reforms, combined with the active use of the exchange rate as an anti-inflationary device, apparently caused a boom in demand for real (mainly real estate) and financial assets, but a rise in consumption as well. There was also an increase in the number of financial intermediaries and the volume of deposits grew significantly. The negative side of this financial "deepening" was a growing fragility of the system, which ultimately ended up in generalized bankruptcy.

The Argentine experiment failed first: bankruptcies of financial institutions started in March 1980 and continued into the following years while a balance-of-payments crisis burst in March 1981. During the period in which the Argentine experience had collapsed while the Chilean had not, the earliest analyses of the Southern Cone experience in terms of sequencing appeared. The first cautions and recommendations on the order of liberalization were based on the comparison between Argentina and the (still at that time) thriving Chilean experience (McKinnon, 1982).

Taking Chile as a standard of "correct" sequencing of policy reform, the Argentine failure was attributed to a "premature" attempt at domestic financial liberalization coupled with the elimination of foreign exchange controls. The attempt was deemed to be premature because it was carried out before the completion of the trade reform and before a sustainable control over the government budget had been attained.

However, in 1982 the Chilean experience also collapsed. This occurred despite the fact that, unlike the Argentine case, the budget of the Government had been showing a substantial and continuous surplus and the trade account had been completely liberalized (McKinnon, 1982). The Chilean case could have been considered as a neat example of an endogenously generated financial cycle, experienced by a private and "liberalized" financial system. However, in the liberalization literature, the research strategy adopted was to examine the process in terms of an erroneous sequencing of reforms. In this way, the analysis developed for Argentina was also, *a posteriori*, taken as valid for Chile. Based on the empirical findings corresponding to the Chilean experience, the role of the destabilizing effects of external capital flows resulting from an untimely or abrupt lifting of controls of the capital account gained ground. Although in the case of Chile, the trade account had been completely liberalized, the standard recommendation became: liberalize external trade first and only then the capital account.

Beyond specific recommendations, an important consequence of the Southern Cone failures was that significant caveats were added to the liberalization optimism of the 1970s. Among the changes in the approach to liberalization in the research literature of the 1980s are three which are very important. First, there is now a much more cautious attitude toward capital flows, to the point that many well-known researchers working on the liberalization research agenda recommend the maintenance of a practically *sine die* control of external capital flows. Secondly, there is a much less naive emphasis on the virtues of domestic financial liberalization. McKinnon, one of the founding fathers of the theory of financial deregulation, in his latest work (McKinnon, 1991) even suggests the need for controlled interest rates during the transition process which is conceived of as taking years. Thirdly, there is a greater concern for the problems posed by stabilization vis-à-vis structural reform: it is now taken for granted that successful liberalization is not possible in a destabilizing macroeconomic environment.

In addition to the Southern Cone failures, another fundamental source of "empirical observations" on sequencing in the liberalization literature is the experience of the Asian NICs, particularly the Republic of Korea. It is normally interpreted that the highly successful far-eastern exporters had performed well because they had relatively free labour markets, a competitive domestic environment and liberalized trade regimes, while regulation of financial markets and interest rates persisted. The stable macroeconomic environment of these countries is likewise emphasized (Krueger, 1983; McKinnon, 1991).[7]

In brief, the most elaborated analyses of the order of implementation of the reform available today are based on a complicated mix of the liberalization-approach theoretical framework (amended to make room for the existence of frictions and short-run rigidities) and "empirical observations" (mainly regarding the experience of the Asian NICs and some Latin American countries) of the kind briefly mentioned above. On these bases, Krueger (1986) concludes that "A plausible argument can be made that optimal dismantling of controls might start with current account transactions, agricultural pricing, and the domestic labor and capital markets, leaving capital account transactions initially subject to controls. These controls would be removed (gradually? suddenly?) in a second stage of liberalization, once domestic resources had responded to altered policy signals" (page 30). These conclusions on the correct order of liberalization may be said to reflect closely what could be considered the market-friendly approach researchers' consensus on the issue.

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[7] In fact, the Republic of Korea had neither a "competitive domestic environment" neither nor "Liberalized trade regime" for the bulk of its growth period. See Amsdem (1989), Westphal (1990).

E. Political constraints on the liberalization process

The most important question addressed in the literature on the political-economy aspects of the transition period of the reform is: how can policies best be selected, phased and sequenced to gain the benefits of reform as quickly as possible while minimizing political resistance? (World Bank, 1987; 1991)

Given that, in the real world, compensation arrangements between winners and losers are deemed to be very difficult or even impossible, it is taken for granted that there will be sectors which will resist the implementation of the reform. Moreover, it is considered that such resistance is likely to take non-economic forms: those whose interests are threatened will use political means to obstruct reform. In this way, political factors enter the analysis of the market-friendly approach as relevant binding constraints on the dynamic path of economic liberalization.

As already noted, there are some problems in attempting to integrate into the analysis the political factors which have a bearing on the reform. In effect, on the one hand, it is recognized that the existence of short-run rigidities and macroeconomic imbalances calls for a sequential implementation of reform but, on the other hand, the need to act decisively is taken for granted: when the policy is hesitant and gradual, liberalization is much more likely to lose momentum as time elapses. In other words, it is considered that the faster and and more profound the policy changes, the greater the benefits, but also, the greater the likelihood that transitional costs will be higher.

Credibility is one of the reasons most often alluded for favouring dramatic changes, the object being to assure greater political sustainability for the liberalization process. It is necessary to enact decisive policy changes because credibility is an essential component of political sustainability. Credibility would be significantly strengthened by a dramatic shift in policy: if the policy change was sharp enough, economic agents would not expect the reform to be quickly or easily reversed.

Another important reason advanced is that a rapid and deep disarticulation of the old regime would not only severely weaken the resistance of "old" vested interests but would also generate "new" ones supporting the liberalized regime (World Bank, 1987). This could be a consistent strategy since the market friendly approach considers it extremely difficult to compensate losers. Equity considerations are obviously left aside.

However, the concern about the disarticulation of "old" vested interests occurring via rapid and decisive measures tends to weaken the Washington Consensus's analysis of the role of the "new" vested interests created by the reform. What would happen to efficiency if a monopoly were privatized and it were not possible to ensure an appropriate regulatory framework either because the State was weak or because the reform was implemented too quickly to be well planned? Even leaving equity aside, do the newly created vested interests better assure market competition than the old ones?

The liberalization literature has taught us much about the possible distortive consequences of protectionism and other interventionist policies, but there is nothing comparable in terms of research effort devoted to analysing what has happened in concrete situations of deregulation. For example, is the privatization process prone to domination by interest groups as was the case with ISI-like policies? Would not such a process open big opportunities for rent seeking and directly unproductive profit- seeking activities?

Indeed, the "market-friendly approach" treatment of the political factors is not always consistent. In order to deduce the theorems that support liberalization policies it is assumed that economic agents are fully rational. It is canonical in this literature to assert that if some opportunity were to be exploited, the private sector would take advantage of it. On the basis of this argument, infant-industry rationales for interventionist policies are discounted (Dixit, 1986). But when treating political factors, the rationality assumption is often weakened. For instance, it is adduced that "the informed public can readily infer those interests which are likely to be damaged in the short run by any liberalization effort; they cannot so readily see the economic activities that were harmed, and hence did not prosper, because of regulations" (Krueger, 1983, page 30). But if not even the "informed public" can envisage the benefits of the reform, who will - in a democratic context - turn public opinion in favour of the reform? This question seems relevant also because there is a generalized impression that the government is not capable of correctly evaluating such benefits, either. According to Edwards (1986), more liberalization attempts are not observed because, among other reasons, the time horizon relevant to a government may be different (shorter) from the time horizon relevant to an economy as a whole. In brief, while the liberalization literature clearly identifies the interest groups and the government goals that sustain interventionism, this is not at all the case with regard to the market-oriented reform.

Given that a good part of this literature is being produced by such institutions as the World Bank and the IMF, one sometimes feels that, in pushing for reform, an important role is implicitly assigned to external advisors. It should be taken into account, however, that in any of the "real world" institutional settings which characterize LDCs or former socialist countries, the State normally has a very reduced capacity not only for regulating the markets - as this literature correctly highlights - but also for properly programming and launching any policy package. If external support is used as the carrot, a government which is highly constrained by its financing needs is very likely to agree on a liberalization package. But if a quick and poorly designed reform is launched, many irreversible policy-induced distortions can result. Their costs could be high and the consequences, even in terms of generating new market distortions, could be long-lasting, as would be the case if an undue concentration of property or a monopoly situation resulted from the reform.

III. The stages of liberalization: individual markets and stabilization policies

According to Michaely (1986), the length and amplitude of the transitional disequilibrium period will be shorter when there are few rigidities in the labour market, less specific physical and human capital, flexible responses by entrepreneurs and a short life-span of physical capital in the contracting activities. Since these characteristics usually differ among sectors, an analysis of the speed with which each stage of the liberalization should be implemented in individual markets is necessary. Because of their importance to the determination of both macroeconomic stability and resource allocation, the study of the speed and attributes of each stage of the liberalization process has focused on an analysis of external trade and the domestic financial market. The role of external capital flows was mainly analysed in relation to trade liberalization and macroeconomic stability, while much less importance was given to the study of the problems posed by the deregulation of labour and other domestic markets. A review follows of the most important features of the sequencing of liberalization in each of these individual markets and the problems posed by stabilization vis-à-vis structural reform.

A. Trade liberalization

The problem of the speed and stages of liberalization of external trade has been very well analysed and empirically documented in the literature. Among the lessons concerning the transitional period which are usually stressed, two have special relevance to the present analysis of the dynamics of the market-oriented reform. First, after extensively reviewing the post-war trade liberalization experiences, the 1987 *World Development Report* states that "there is no single optimal path to reform" (World Bank, 1987). Although a sensible lesson, given the multiplicity of cases reviewed, it is in flagrant contradiction with the search for the optimal path alluded to elsewhere in the literature. Secondly, there is a wide consensus on the fact that trade liberalization is a long-lasting and difficult process. According to McKinnon (1991), a precipitate move towards free trade could provoke the collapse of manufacturing. In support of this assertion, he mentions the cases of the eastern part of Germany and of Poland, but he could also have mentioned many Latin American countries that implemented trade liberalizations in the 1970s and 1980s. In the same vein, the 1987 *World Development Report* affirmed that successful liberalizations were very lengthy. Countries such as the Republic of Korea or those in southern Europe had still not completed the trade reform even after *two decades*. This seems to be at variance with the shorter time span assigned to the reform in the 1991 *WDR* and with that which is implicit in the Washington Consensus recommendations.

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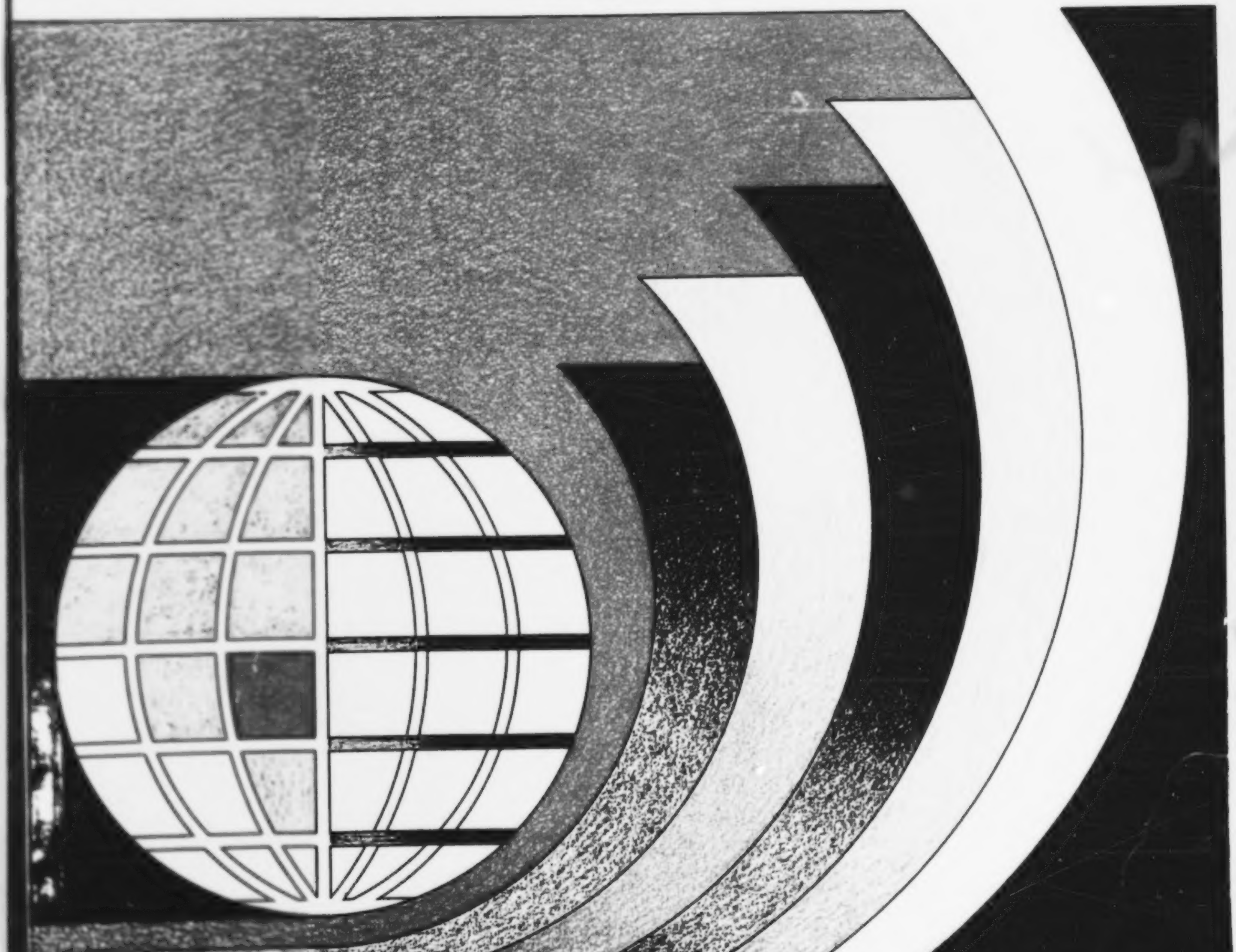

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Introduction

The Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24) was established in November 1971 to increase the negotiating strength of the developing countries in discussions that were going on at that time in the International Monetary Fund on reform of the international monetary system. Developing countries felt that they should play a meaningful role in decisions about the system, and that the effectiveness of that role would be enhanced if they were to meet regularly as a group, as the developed countries had been doing for some time in the Group of Ten (G-10).

It soon became apparent that the G-24 was in need of technical support and analysis relating to the issues arising for discussion in the Fund and Bank, including the Interim and Development Committees. In response to representations by the Chairman of the G-24 to the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD), and following discussions between UNCTAD and the United Nations Development Programme (UNDP), the latter agreed in 1975 to establish a project to provide the technical support that the G-24 had requested. This was to take the form, principally, of analytical papers prepared by competent experts on issues currently under consideration in the fields of international money and finance.

Mr. Sidney Dell, a former Director in UNCTAD's Money, Finance and Development Division and subsequently Assistant Administrator of UNDP headed the project from its establishment until 1990. During this period, some 60 research papers were prepared by the Group of Twenty-Four. The high quality of this work was recognized by the Deputies and Ministers of the Group and the reports were given wide currency, some being published in five volumes by North-Holland Press and others by the United Nations.

The project work was resumed in 1990 under the direction of Professor G.K. Helleiner, Professor of Economics, University of Toronto, Toronto, Canada. The UNCTAD secretariat continues to provide both substantive and administrative backstopping to the project. Funding is presently being provided by the G-24 countries themselves, the International Development Research Centre of Canada and the Government of the Netherlands. As a result, it has been possible to continue to provide the Group of Twenty-Four timely and challenging analyses. These studies are being reissued periodically in compendia. This is the third volume to be published.

ENHANCING THE COST-EFFECTIVENESS OF AFRICA'S NEGOTIATIONS WITH ITS CREDITORS

Tony Killick*

Executive Summary

The focus of this paper is on the costs to the Governments of Africa of negotiations with what can generically be described as their creditors. The focus is on **cost-effectiveness**, *rather on the absolute level of costs, because superior effectiveness may make it desirable to opt for approaches which are demanding administratively and in other ways. The post-Toronto "menu" approach is a case in point.*

In section I evidence relating to the cost-effectiveness of present arrangements is presented. Section II examines the sources of sub-optimal cost-effectiveness. The general theme is that there are substantial avoidable transactions costs, analogous to market imperfections, and that a major part of the problem stems from weak institutional provisions for safeguarding the general (international) interest over the interests of particular creditors. The concluding section III therefore suggests ways of strengthening such institutional provisions.

As regards cost-effectiveness, past approaches have been seriously sub-optimal. The information, opportunity and other economic costs of negotiations are large. A rough estimate of the number of negotiations in 1980-1992 approaches 8,000. Probably the chief costs involved are the opportunity costs resulting from the large demands placed by multiple and complex negotiations upon the key cadre of officials dealing with the design and management of economic policy. In addition, there are substantial information costs, although these have diminished over time and much of the information secured as a result is of genuine value. There are also financial costs arising from various delays, and investor risks arising from uncertainties generated by frequent policy changes, incomplete implementation and doubts about the political sustainability of adjustment.

Concerning the effectiveness of the process, through most of the 1980s debt reschedulings in the Paris and London Clubs were inappropriate for the economic situations of most African debtor countries. The short-term nature of reschedulings maximized the costs involved, while offering only the most temporary financial benefit to debtor governments. Moreover, evidence is presented showing that the effectiveness of the programmes negotiated with the IMF and World Bank is patchy. There is much room for improvement in both costs and effectiveness. The Governments of Africa are, moreover, particularly at risk from this sub-optimality because most are reliant on rescheduling arrangements and aid, and are weak in geopolitical terms.

A number of causes of the sub-optimalities are identified. One was the retreat in the 1980s from international cooperation and the resultant shifting of the costs of international economic instability on to debtor countries. This deterioration in the balance between financing and adjustment has resulted in the manipulation of negotiation procedures to understate deficit countries' financing needs, insistence on unrealistic programmes and the under-funding of adjustment programmes. The associated retreat from contingency financing has also left deficit countries more exposed to exogenous shocks, adding to the frequency with which they need recourse to negotiation and pushing agreed programmes off course.

Interest conflicts among creditor countries, and between them and debtor countries, have also taken their toll, resulting in preoccupation with burden-sharing and "lowest common denominator" outcomes. Most fundamental of all is the basic asymmetry of power in the negotiations. In the absence of effective institutional safeguards, this allows creditor interests to insist upon terms that are not cost-effective when seen from a global viewpoint. It has also allowed a denial of transparent, rules-based processes, paving the way for the unequal treatment of like cases, often in pursuit of creditor countries' commercial and foreign policy objectives. This, in turn, has increased transactions costs and the frequency of ineffective, politically-motivated adjustment programmes.

Lastly, we stressed the adverse effects of the conditionality explosion of the last decade. Besides adding to the burden of work in debtor countries, and the related information and opportunity costs, this has also increased pressures for "off-the-peg" programmes of International Financial Institutions (IFIs),

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* I am indebted to Stephen Bailey-Smith for valuable assistance in preparing materials for this paper and to Matthew Martin for valuable comments on an earlier draft.

which are not best designed to fit local circumstances, and has weakened borrowing governments' ownership of agreed adjustment programmes - both factors which weaken programme implementation and cost-effectiveness. It has also heightened the risks for investors arising from uncertainties about policies and their sustainability.

Since the 1988 Toronto conference, changes have been introduced that have increased the financial benefits derived by African countries from Paris and London Club negotiations, increasing the viability of the process and in some measure reducing uncertainties. The Toronto and post-Toronto terms have also increased transparency by more precisely defining the terms which creditors must offer in bilateral negotiations. The Special Programme for Africa (SPA) appears to have been quite effective in mobilizing additional finance (including aid debt write-offs) for eligible countries, and in improving the coordination and quality of aid. The framework as laid out in the Policy Framework Paper (PFP) is apparently working better as a mechanism for increasing the say of governments in programme design, and for aid coordination, in which task Consultative Groups reportedly have also increased their effectiveness.

These are real gains, reflecting a more realistic creditor view of Africa's economic situation. At the same time, even the post-Toronto terms provide inadequate debt relief, with further progress obstructed by the lowest-common-denominator factor. The conditionality explosion is intensifying rather than abating, as is the frequency of IMF programme breakdowns. And not all African countries have been able to take advantage of the improvements, depending on the eligibility criteria in operation.

The thrust of the paper's policy recommendations is addressed to the inefficiency of present arrangements and the need to strengthen the incentive structures for securing improvements. We view the sub-optimal cost-effectiveness of existing arrangements as a form of transactions cost and the essence of any systemic reform as requiring the establishment of institutional arrangements to safeguard collective over individual interests, so as to minimize the transactions costs of debtor-creditor negotiations.

There have been a number of past attempts to fill this institutional gap: UNCTAD, the DAC, the Consultative Group and Round-table arrangements. Indeed, the IMF and World Bank could be seen in this light, although they are too dominated by creditor interests to be wholly effective guardians of the international interest. The paper's principal recommendation takes up a suggestion for the creation of Adjustment Review Consortia. Under these, aid and debt relief negotiations would be merged into a single process, combining the subject-matter of the present Paris Club and Consultative Group (and similar) negotiations. This would be intended both to reduce the burdens on debtor-government administrations and to increase the incentives for implementation of adjustment programmes, thus addressing the sub-optimality of both the costs and effectiveness of the present situation. Such Consortia could also provide a forum in which IFIs and bilateral agencies collectively agree to limit the coverage of their conditionality to a manageable number of priority items.

Various more specific suggestions are also made: to simplify, and increase the transparency of, the processes; to improve provisions for contingency financing, and eligibility for favourable treatment; and to strengthen African Governments' own contributions to the cost-effectiveness of their negotiations with their creditors.

Introduction

The focus of this paper is on the costs to the Governments of Africa of negotiations with what can generically be described as their creditors. Such negotiations include not only those concerning debt *per se*, mostly conducted through the Paris and London Clubs, but also negotiations with donor governments and international agencies (chiefly the World Bank) for official development assistance, and with the IMF for balance-of-payments assistance.

In approaching this task it is necessary to draw some boundaries. The first is around the types of costs to be considered. During the past decade almost all the negotiations mentioned above have been concerned with, or predicated on the existence of, an adjustment programme of policy reforms agreed with the IMF and/or World Bank. Such programmes impose costs on the economies in question (as well as conferring benefits) and there is a substantial literature on these. It is not our task to revisit this familiar territory. We shall focus more narrowly on costs specific to the negotiation process itself, as distinct from those associated with the policy content of the resulting programmes. On the other hand, we attempt to take in the costs of implementing and monitoring the programmes on the grounds that these are influenced by the negotiation process.

Secondly, it does not seem sensible to examine the costs in abstraction from the effectiveness of the negotiations. For example, the "menu" approach adopted to secure agreement on what are known as the Toronto terms undoubtedly made greater negotiation demands on debtor governments than a single agreed set of terms but this approach can be seen as a necessary device for securing creditor agreement on what, overall, was a considerable improvement over the debt renegotiation terms previously available. The menu approach could thus be seen as cost-effective even though it raised negotiation costs. A second example is provided by the negotiations associated with use of the debt buy-back facilities that are now available. These are demanding, but the potential benefits of reducing debt obligations in this way are substantial.

In both these cases, to incur the additional negotiation costs involved may well be justified by the extra benefits secured, so the focus of this paper is on *cost-effectiveness* rather on the absolute level of costs. However, in looking at effectiveness we will try to limit ourselves to "objective" indicators, such as programme breakdowns, and to avoid the wider debate about the appropriateness of the policy conditionality associated with creditor negotiations - an important topic which, however, lies beyond our remit.

In section I evidence relating to the cost-effectiveness of present arrangements will be presented. Section II, which is the core of the paper, examines the sources of sub-optimal cost-effectiveness, including the unfavourable balance struck between financing and adjustment; interest conflicts among the various parties; the lack of transparency in present arrangements; and the spread of creditor conditionality. The general theme that emerges is that there are substantial avoidable transactions costs, analogous to market imperfections, and that a major part of the problem stems from weak institutional provisions for safeguarding the general (international) interest over the interests of particular creditors. The concluding section III therefore suggests ways of strengthening such institutional provisions in order to increase the cost-effectiveness of African Governments' negotiations with their creditors.

I. Evidence on cost-effectiveness

It must be confessed straightaway that only anecdotal or indirect evidence can be offered. The costliness of negotiations is an inadequately studied area. It would require investigations of the direct and indirect costs associated with a substantial number of specific negotiations for a more authoritative analysis to be offered but to undertake such country-based research was beyond the resources available for this study.[1] Nevertheless, a substantial amount of evidence is available relating both to negotiation costs and the effectiveness of the negotiated outcomes. We examine first the evidence available on costs.

A. Negotiation costs

1. Information costs

The importance of adequate and reliable information for negotiations is obvious. Without it the problem cannot be properly defined, the proposed solutions can only be hit or miss, the needed volume of supporting finance can only be guessed at. Moreover, possession of information bestows negotiating strength. The team with an inferior data base will always be at a disadvantage; and a government that does not have good information about the economic situation is unlikely to be able to prepare a convincing package of policies, leaving it more vulnerable to external pressures.

The data problem was most notoriously present in the earlier debt negotiations of the 1980s. Large resources had to be devoted to the collation of debt statistics but Paris Club meetings were still presented with debt data suffering from error margins of ± 20-30 per cent, with special problems encountered over statistics on government-guaranteed debt incurred by public enterprises and private-sector borrowers. Sometimes the resources involved in correcting this situation were really large: in Nigeria it took years to build up an accurate record; in the United Republic of Tanzania it took a full-time eight-person team more than a year; Zambia also experienced substantial difficulties (Goreux, 1993, p. 60).

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[1] An attempt was made to fill the gap to some extent by requesting central banks to complete a detailed questionnaire on experiences with negotiations. Unfortunately there was only a very limited response to this request, possibly because of the sensitivity of the information sought - to say nothing of the costs involved.

Not the least of the costs associated with this situation was the diversion of the limited number of available officials with relevant expertise from the preparation of their countries' negotiating positions and policy proposals. Thus, Martin, Mistry *et al.* (1991, p. 100) on Paris Club negotiations:

> Some debtor governments had become bogged down in data and documents, to the detriment of preparing *negotiating strategy*. They lacked a clear definition of the interests of the government and its foreign exchange requirements. They had no time for advance talks with the main creditor governments, or with third parties ... who could influence creditors and assess their flexibility. Nor were they able to monitor details of recent terms received by other governments with similar income levels and degrees of debt servicing problems: this often led them to rely on inaccurate advice which underestimated the debt relief or new aid creditors could provide. Above all, they had not identified the amount due in the 12-36 months after rescheduling if various terms were agreed, which was a key influence on the sustainability of agreements.

As experience and information have accumulated with repeated rescheduling negotiations, and the availability of technical assistance and computer-based data management systems has grown, information on debt has improved. It is rare nowadays for there to be great difficulty in reconciling data on the debt of countries that have become veterans of such negotiations, but some countries have learned more readily than others and some are still relatively inexperienced. There can also be considerable problems with the morale, incentives and continuity of staff, which reduce learning externalities.

Recent provisions have, moreover, created additional informational burdens. The adoption of the menu approach has already been mentioned, as have the complications created by London Club provisions for debt buy-backs. Mozambique and the United Republic of Tanzania reportedly spent over two years attempting to reconcile data and hire advisers to take advantage of this provision but only Mozambique has so far been rewarded with success.

Even before the necessity of debt negotiations arose, the information costs of dealing with the IMF and World Bank (hereafter the International Financial Institutions, IFIs), and bilateral and other sources of aid were already notorious. For the staffs of Ministries of Finance and Central Banks the imminent arrival of an IMF mission has always signalled much information-gathering work. As the World Bank has moved increasingly into "policy-related lending" during the last decade or more, it too has made increasingly large demands. So have some bilateral donors as they have increasingly linked their aid to policy conditions of their own.

The costs involved in the provision of the information needed for the various negotiations must have been large. On the other hand, we should recognize that there have been benefits too because the flow of economic data has in many cases been improved, with consequential potential for improving decision-making. To quote a central bank respondent:

> ... the process of information-gathering threw up new and vital information. A case in point is the discovery of previously unknown borrowings and unauthorised expenditures when we attempted to monitor [government] borrowing from the central bank in line with the programme. Furthermore, the pressure to review our information base critically has yielded positive results.

Such benefits need to be set against the costs. The costs are most liable to dominate for data which are called for not because of the value of the information they convey but because of the organizational, policy and accounting quirks of the creditor organizations - categories of sometimes considerable size. The same source again:

> At times, however, technical staff spent inordinate amounts of time answering data queries from the multilaterals. This was especially unsatisfactory as there were many missions, many of whom addressed the same issues, and required the same detailed discussions with our staff. There was a general lack of co-ordination between the World Bank and the IMF.

2. *Opportunity costs*

In addition to the staff time and other resources devoted to the collection of information there are various demands on staff time which - in addition to their direct payroll costs - divert officials from other duties. It is impossible to quantify such opportunity costs, or to offer systematic evidence on them, but there is persuasive indirect evidence that they can be substantial.

One is the time-consuming complexity of the negotiation task and the multiplicity of forums through which it must be conducted.

During the course of a year the key economics officials of a typical African country can expect between them to have to prepare, and conduct discussions for, all or most of the following purposes:

- ***Dealing with IMF missions***. At a minimum, there will be annual consultation missions. If the Government has requested a Fund credit, there will be a series of altogether more demanding meetings in support of that request. If there is already a Fund programme, there will be three- or six-monthly review missions to deal with. There may additionally be a resident Fund mission, which will also require attention (although a mission can also be an aid).

- ***Dealing with World Bank missions***. These will create demands comparable with those of the Fund, except that the Bank's interests will be more wide-ranging and the burden can probably be spread over a larger number of government agencies and officials.

- ***The Paris Club***, to reschedule official or officially-guaranteed debt. These meetings normally only last one or two days but involve much preparatory work and have typically consolidated debt only for about 15 months. Furthermore, Paris Club agreements are only put into effect through accords with each of the creditor governments involved, which may necessitate the negotiation of 10 or more separate bilateral agreements.[2]

- ***The London Club***, which deals with commercial bank debt. Although such debt is generally not a large part of the obligations of African countries, most owe some such debt. The procedures and requirements of the London Club can be particularly onerous, and are sometimes disproportionate to the modest sums owed.

- ***Negotiations with other creditors***, who do not belong to the Paris and London Clubs, notably the Governments of former Eastbloc countries and of OPEC, and non-bank commercial creditors.

- ***Consultative Groups*** or similar collective aid coordination meetings, which usually meet annually and require substantial documentation from the governments.

- ***Aid negotiations*** with bilateral donors and other multilateral bodies including the United Nations agencies and the African Development Bank.

Some idea of the number of negotiations resulting from this multiplicity of forums can be obtained from statistics of World Bank adjustment loans and Paris Club and London Club debt rescheduling in sub-Saharan Africa. During 1980-1992 these totalled no fewer than 535 agreements in a total of 39 countries of sub-Saharan Africa.[3] These statistics, of course, exclude negotiations that did not result in agreement, as well as bilateral debt and aid negotiations. If we assume 10 bilateral debt negotiations for each Paris Club agreement, that would imply about 1,500 bilateral debt negotiations by 30 African Governments in 1980-1992.[4]

The number of bilateral aid donors to be dealt with can also be considerable. According to Cassen (1986, p. 219) an average of 25-30 aid agencies operate in an average country at any one time, each with its own spending priorities, accounting and administrative procedures, agreement periods and financial years, and disbursement conditions. The total resulting number of projects can be frighteningly large. Riddell (1987, p. 210) cites estimates of 600 projects from 60 donors in Kenya; 321 projects from 61 donors in tiny Lesotho; and 614 projects from 69 donors in Zambia. If we assume that each African Government undertakes one negotiation each with an average of 10 donors a year (which may well be an understatement), that would add another 450 per year or, say, 5,800 over 1980-1992. Together these various figures add up to over 7,800 negotiations over a 13-year period. Obviously, no great accuracy can be claimed for this estimate, although we do not think it is biased upwards. Even if we were to reduce the figure to 5,000, the number is remarkable.

Evidently, the volume of work involved in servicing all these negotiations is colossal. The potential opportunity costs are hence large, especially since the brunt of the work is often borne by the same small group of key economics officials who would be best qualified to advise the government on economic policy if only they had the time. Moreover, while there is some sequencing, with agreement with the IMF usually preceding meetings of the Paris and London Clubs, some of the above tasks can arise more or less simultaneously. Martin (1991, p. 198), for example, writes of a period in 1987 when the Nigerian authorities were simultaneously but separately conducting negotiations with the IFIs and the Paris and London Clubs.

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[2] One of the larger African debtor countries has listed no fewer than *19* creditor countries with which separate negotiations had to be completed under the Paris Club terms.

[3] Derived from World Bank (1992a, table A1.5, and 1992c, appendices II and III); and *Annual Reports* and other publications of the IMF.

[4] The World Bank (1992c, appendix III), records 154 London Club agreements with African countries in this period.

In addition to this multiplicity of negotiating forums, other forms of proliferation have occurred which place large additional demands on key officials. Perhaps the most notable in recent years has been the movement of the World Bank since the late 1970s into "policy-related" lending, which will be taken up later. At the same time, with the introduction of its Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF), the scope of the IMF's policy conditionality has also widened, and we shall later show that there have been other developments within the Fund to increase the demands it makes on the economic administrations of borrowing countries. Various other donor agencies have joined in with their own conditionality, generally supportive of that of the IFIs but creating extra burdens.

Poor coordination between the IMF and World Bank can add further to the work load, despite improvements in recent years. One respondent cites the case of a Bank-led mission to evaluate the foreign exchange system, whose work (and that of the government officials who had assisted it) was subsequently aborted by IMF insistence that it was the Fund which should deal with such issues. The differences in approach of the two agencies in their "gap" calculations is a more fundamental source of difficulty.

Already impossible demands can be further aggravated by the effects of staff turnover, which weakens the learning process and creates the need to "break in" new participants. While, in principle, turnover in the "home team" is under the control of the Government, changes in the personnel of the IFI creditor teams are beyond their control. An official of an African Government writes of the problems caused by lack of continuity in the "away team":[5]

> To give an example, a new Exchange and Trade Relations man was sent with the IMF mission earlier this year. It took at least two missions for him to get to grips with [this country's] case, and only on his last mission did he look comfortable. However, he has been transferred so the next mission will bring a new ETR man. This will significantly increase my workload as I will have to "educate" him on [my country], answer endless questions and supply lots of information that has already been given in the past. This has also been the case in other areas of the "away team".

The cumulative effect of all these demands cannot fail to have large opportunity costs, diverting senior personnel from tasks with potentially higher economic pay-offs. In extreme cases, it can bring the administration to breaking point, so that an internal IMF staff report writes of severely limited administrative capacities resulting in implementation problems that were compounded when governments faced large numbers of policy commitments to the Fund, Bank and other agencies.[6]

3. *Other costs*

Although they are harder to pin down and the evidence is more impressionistic, there are liable to be substantial costs additional to those already described. The complexities of the negotiation processes described above may, for example, result in financial costs. A major example of this arises from the procedures of the Paris Club. There are commonly considerable delays between agreement at the Paris Club and conclusion of the bilateral accords which give it effect,[7] and this can lay debtors open to various penalties: late interest charges; delays in the restoration of export credit cover; and the postponement of subsequent negotiations, although Goreux (1993, p. 34) suggests that in practice the consequences have not been too serious.

More serious in some cases have been losses in aid disbursements as a result of the delays, which can be large. All these forms of financial cost impact adversely on the budget, and can lead to additional difficulties in complying with IMF credit ceilings, tending to set up a vicious circle of delays, budget difficulties, breakdown of IMF programmes and further difficulties with the Paris Club. The same costs can also lead to shortfalls of import capacity, impacting adversely on economic activity, human welfare and the sustainability of attempts at economic restructuring.

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[5] Private correspondence.

[6] From an unpublished 1990 review of experiences with SAF and ESAF programmes (p. 37).

[7] Of the 33 Paris Club reschedulings studied by Goreux (1993), only 59 per cent of bilateral agreements were completed within eight months of the Paris Club agreement and delays exceeding a year were not infrequent.

There can also be adverse economic effects from the uncertainties and delays involved. Even if it is agreed that creditor-prescribed programmes move policies in desirable directions, the result may be to reduce policy continuity and increase uncertainties about the future policy environment - particularly when programmes are first adopted or where there are doubts about the sustainability of the policy changes adopted. Such uncertainties increase the riskiness of using present prices and policies as a basis for investment and other decisions about the future. This is liable to dampen investment and growth, and to lower responsiveness to price incentives.[8]

An additional source of uncertainty, and a factor which also deserves to be counted as a cost in its own right, is the political destabilization that sometimes accompanies negotiations and delays in these. While there is no evidence that negotiations have systematically destabilizing effects,[9] there are specific instances where this has occurred, usually related to negotiations with the IMF. Martin (1991, p. 39) cites a number of these: in Burkina Faso, Ghana, Mali, Mauritania and Nigeria.

B. The effectiveness of outcomes

In addition to examining the evidence on the costliness of the process we also need to ask about the effectiveness of the outcomes. As mentioned earlier, we want to avoid entering into the large debate about the appropriateness of the policy conditionality of the IFIs and others, because that would take us too far from our remit. However, even if we are willing to assume that the policy changes incorporated in programmes generally represent improvements, there is other evidence which calls the effectiveness of the process into question.

We can first cite the frequency with which programmes break down or are seriously delayed. This is best documented in the case of the IMF. Killick, Malik and Manuel (1992, table 2) have shown that in 1980-1990 about half (52 per cent) of all Fund programmes broke down before the end of their intended lives, with the same breakdown rate in Africa as for the whole sample. Moreover, they show a deteriorating trend over time, with a 67 per cent failure rate in 1987-1990. On the basis of a survey of other studies and their own research, they also find that the changes in economic performance associated with IMF programmes are only mixed (Killick and Malik, 1992, pp. 629-630). The balance of payments is generally strengthened and programmes have a more sustained influence than often supposed. But programmes have little revealed impact on the growth of the economy or on the inflation rate, and do not appear to exert a decisive influence on fiscal and monetary policies. In short:

> The world, it seems, over-rates what the Fund can realistically hope to achieve, and the amount of leverage which it exerts over policies. With the important exception of the exchange rate, the evidence suggests rather limited impact upon the fiscal and monetary instruments which are central to its programme designs ... Given the Fund's limited revealed leverage over these other policy variables, it is scarcely surprising if the macroeconomic results of its programmes fall well short not only of intentions but of the degree of sustained improvement necessary to ensure credibility for government policies and to revive investor confidence.

These conclusions were drawn from evidence relating to all developing regions but the general view is that the effectiveness of Fund programmes in Africa has been particularly slight.

A substantial proportion of World Bank structural adjustment programmes also suffer from serious delays (usually because of noncompliance with policy stipulations) and occasionally break down altogether. A recent analysis of such programmes in sub-Saharan Africa (World Bank, 1992b, annex 10) indicates that 55 out of 146 operations were subject to this type of problem, with an average delay of 434 days, meaning that they took nearly twice as long to be completed as originally intended.

Accumulating evidence on the impact of such programmes similarly points to the limitations of what they have been able to achieve, particularly in Africa. A number of multi-country studies arrive at similar conclusions:

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[8] On this see Rodrik (1991), who argues that even moderate uncertainty about policy acts as a substantial tax on investment, and that "reform packages which emphasize policy stability and sustainability are likely to bring greater payoffs in terms of investment and growth than those which focus on economic liberalization and getting prices right" (pp. 240-241).

[9] This topic has chiefly been investigated in relation to IMF programmes. Siddell (1988) concludes from a large sample of cases that an IMF programme does not significantly increase or promote political instability, although his study is confined to 1969-1977. A more up-to-date study of the African situation by Moore and Scarritt (1990) similarly concludes that Fund programmes have no significant impact on the nature of African Governments.

that Bank programmes are associated with improved export and balance-of-payments performance, reduced investment levels and little or no effect on GDP growth. In the Bank case, however, the impact of programmes in African countries has been singled out for specific study. Nooter and Stacy (1990) utilized in-depth studies of seven African countries, concluding that (p. 14):

> Only three of the seven countries under review (Ghana, Guinea and Madagascar) appear to have adopted adjustment programmes which are broad and deep enough to constitute effective, growth oriented adjustment programs. Even in these cases, further adjustment measures will be necessary. Since the seven countries under review are considered by the Africa Region [of the Bank] to have the most effective programs of the region, it can be assumed that the adjustment programs not reviewed here are also not yet fully comprehensive (with the exceptions of Gambia and Mauritius ...)

(It can be added that of the three singled out in the above quotation only in Ghana has the programme remained on track.) A recent internal Bank evaluation of experiences with adjustment lending (1992a, chapter 1) found markedly weaker results for African and other low-income countries than for middle-income adjusting countries. Another recent Bank study has the remarkably frank title, "Why structural adjustment has not succeeded in sub-Saharan Africa." This (Elbadawi *et al.*, 1992) and a companion paper (Elbadawi, 1992) both find that while the Bank's structural adjustment programmes in Africa have significantly improved export performance, this has not been sufficient to counteract the strongly adverse effect of programmes on investment, so that there was no revival of economic growth.

In brief, then, it appears that the adjustment programmes that are intended to underpin most of the negotiations described earlier are only able to achieve modest results, although the balance-of-payments improvements are important. There are many factors contributing to this outcome, not least the force of external shocks, but the limited results achieved do add weight to doubts about the cost-effectiveness of the processes analysed here.

This point is given added weight when we examine the nature of the debt agreements arrived at by the Paris and London Clubs until recently. By common consent, until the adoption of the Toronto Terms in 1988 Paris Club reschedulings were harsh and ultimately non-viable. They were excessively short term and embodied non-concessional moratorium interest rates which added to the debt burdens of African countries and resulted in ever-rising debt and debt-servicing ratios. In effect, they did little more than provide a *de jure* recognition of the *de facto* inability of many African countries to service their debts, providing paper increases in liquidity in return for additional high-cost debt. The present position is more favourable, as will be shown later, but until 1988 the absence of any genuine concessionality in Paris Club terms raises the question of whether, from the point of view of the debtor governments, it was worth incurring the costs of negotiating such agreements.

The same question does not arise in connection with negotiations for bilateral development assistance, for most recent aid to Africa has been in the form of grants or very soft loans. However, even here there are debit entries in the ledger in the form of hidden costs which reduce the net value of the aid received.[10] Probably the most serious of these is the practice of procurement-tying.[11] Although this is sometimes defended as a way of increasing public support for aid or as a tactical weapon to use in persuading other donors to reduce their tying, the principal motive is protectionism. The precise extent of tying is difficult to state because of the existence of informal as well as formal arrangements and because of the possibilities for fungibility. Including informal as well as formal arrangements, probably 40-50 per cent of total OECD aid is procurement tied and there is no clear downward trend. Tying reduces the quality of aid by imposing costs on recipients, transferring some of the value of aid from them to beneficiaries in the donor country. The direct cost is the extra price which the recipient has to pay as a consequence of being unable to shop around on world markets for the best buys. Most estimates of this place the surcharge in the 15-30 per cent range, although there are "horror stories" involving far higher costs.[12]

In addition, there are indirect costs. Tying, and the commercial objectives which underlie it, introduces biases in donor project selections in favour of capital- and import-intensity, often to the detriment of developmental priorities. Tied aid is liable to incorporate inappropriate technologies or to foster a proliferation of technologies. It places more demands on recipients' scarce administrative resources, introducing more complicated procurement and disbursement procedures and thus an additional source of delay in utilizing the aid. Similar criticisms apply to mixed credits - the blending of concessional assistance with export credits.

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[10] For a general survey see Killick (1991, pp. 35-44).

[11] See Jepma (1991), for an excellent review of this subject.

[12] Jepma (1991, chaps. 7 and 8). See also Riddell (1987, p. 209).

There are other factors that further reduce the net value of aid: the difficulties of donor coordination and the resulting proliferation problems already mentioned; the added difficulties of budgetary control resulting from certain donor practices; biases towards large, capital- and import-intensive projects, and inappropriate production and management technologies. All these factors diminish the cost-effectiveness of aid negotiations from the recipient's viewpoint.

To sum up, in terms of both costs and effectiveness, there are good reasons for doubting the optimality of past approaches. The information, opportunity and other economic costs of negotiations can be large; effectiveness is patchy. Certainly there is much room for improvement of both dimensions. The countries and Governments of Africa are, moreover, particularly at risk from this sub-optimality. Most are heavily indebted and reliant on rescheduling arrangements. Aid dependence is particularly severe.[13] Data availabilities and public administrations are especially weak. Economic confidence is particularly fragile. Being generally small, economically weak and geo-politically unimportant, they are more likely to be put upon by rigorous conditionality than other developing countries.[14] In consequence, as Campbell and Loxley (1989, p. 1) have put it, "not since the days of colonialism have external forces been so powerfully focused to shape Africa's economic structure and the nature of its participation in the world system."

As already indicated, the cost-effectiveness situation has improved in recent years but before assessing these improvements we will next examine the sources of the sub-optimality revealed above.

II. Sources of sub-optimality

As might be guessed, a large number of factors have contributed to the situation of sub-optimality. These will be discussed under four headings: the deteriorating financing-adjustment balance; interest conflicts; the absence of transparency in the process; and the spread of conditionality.

A. The deteriorating balance between finance and adjustment

During the first three post-war decades there was fairly general agreement on the proposition that international economic instability calls for internationally cooperative solutions. More specifically, it was regarded as unacceptably harsh and inefficient that countries pushed into payments difficulties because of adverse external shocks should be forced to cope by deflating their economies, and there was a degree of consensus that when adjustment measures were needed they should be adequately reinforced with supporting international finance if the consequences were not to be unacceptably deflationary. Financing and adjustment were seen as complementary, to be kept in balance with each other.

The last decade or so has seen a retreat from this consensus. The balance has shifted towards requiring deficit countries to undertake more adjustment and nowadays the emphasis is on the "moral hazard" risks of financing deficit countries. This change of climate affects the subject in hand in two principal ways: by causing the underfunding of programmes and through refusals to respond internationally to the adverse effects of external shocks.

The researches of Martin, Mistry and their associates have thrown much light on this in the context of African debt negotiations. Their special focus has been on the procedures employed in the projection of balance-of-payments and financing gaps during the negotiation of IMF and World Bank adjustment programmes.[15] The central facts are that what ought to be objective technical exercises are actually negotiated outcomes, the determination of which occupies a disproportionate amount of negotiating time, with the IFIs having the dominant say. There are, moreover, systematic biases in the resulting gap calculations, with data and estimation methods manipulated in order to avoid the generation of inconveniently large financing or "adjustment" gaps.

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[13] Killick (1991, table 1), shows that in terms of aid per capita, and as proportions of investment and imports, the aid disbursements of sub-Saharan African countries in 1980-1988 exceeded those of other developing countries by factors of between five and ten.

[14] Mosley *et al.* (1991, I, p. 125) conclude from their study of World Bank structural adjustment programmes that: "The poorer the recipient's initial political bargaining position ... the more stringent the conditions imposed on it, regardless of the severity of the level of economic mismanagement ..." Stiles (1991, p. 36) similarly reports that large, important countries are liable to get special consideration within the IMF, while small, unimportant ones are treated more routinely.

Killick and his associates are among those who have noted a systematic tendency for Fund staff to be over-optimistic in their economic projections and programme designs.[16] Apart from a natural tendency to over-optimism, a more likely general explanation is the pressure to which Fund missions are exposed to reach an agreement in the face of constraints on their ability to change policies, or on the power of those policy changes to bring about improvements. In such situations there is a temptation to massage the figures, to come up with seemingly plausible projected outcomes in support of an agreed set of measures although the mission may privately have doubts about the feasibility of the predicted outcomes.

Martin (1991, pp. 76-77) provides further evidence of consistent over-optimism by the Fund and (pp. 63-65) a specific example of the manipulation of payments projections for Zambia in 1987, when there were a host of last-minute changes to projections for 1987 in order to show an acceptable financing gap. These included further reductions in imports following large cuts in 1986. As an IFI participant told Martin: "Cutting imports was the worst idea for the economy, on top of the 1986 import shortfall. But we had no choice if we were to make arrears to the Fund seem payable - the reason why the manipulation was worse than usual" (note the "worse than usual"). The World Bank has a similar, rather well-known, tendency to over-optimism as regards terms of trade and export prospects.

The necessity for all this manipulation and wishful thinking, of course, arises from the severity of the constraints on available supporting finance. Creditor governments do not wish to be told that substantially more financial support or debt relief is needed than they are prepared to make available, any more than the Board of the IMF is happy when it is told that countries' balance-of-payments recoveries are likely to be slower than is implicit in the time-spans of IMF programmes.

The inevitable consequence is that a good many of the agreed programmes are unrealistic, fated to break down because of underfunding and shortages of foreign exchange. A former head of the key Exchange and Trade Relations Department of the IMF has stated privately that up to a third of the programmes are inadequate and doomed from the start. This, and the underfunding which leads to it, both add to the negotiation costs by introducing protracted but ultimately fruitless arguments about the values that should be included in payments projections, and reduce programme effectiveness because of the consequential frequency of breakdowns and adverse effects on the credibility of the announced policy measures.

Goreux (1993, pp. iv-v) is among those who have similarly criticized the high consolidation interest rates incorporated in earlier Paris Club reschedulings (which can be regarded as another aspect of inadequate financial support) as leading inevitably to unviable programmes:

> The system was bound to lead to repeated reschedulings, to an exponential growth in the stock of debt and the debt service ratio and, consequently, to an ever increasing probability that this debt would never be repaid in full.

Killick *et al.* (1992, table 3 and *passim*) found further evidence consistent with under-funding as a cause of programme breakdown. They examined the size of Fund credits (net of return flows) during the 1980s and, while they were favourably impressed with the average size of credit relative to the initial payments deficit, they noted a significant difference between the situations of countries completing their programmes and those whose programmes broke down before completion. The agreed credit size for the latter countries was less than two-fifths of the credits of the former group, expressed relative to the initial current account deficit. They also show (p. 593) that, contrary to the Fund's aspiration to have a catalytic effect in capital inflows from other sources, *in*

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[15] I am here drawing particularly on the preliminary results of a project on "External finance for African development in the 1990s" presented in Martin, Mistry *et al.* (1991) and in various supporting country studies. See also Martin's 1991 study of African debt negotiations.

[16] The reference here is to work undertaken in connection with the research reported in Killick *et al.* (1992).

the average case the net effect is a reduced capital inflow, chiefly because Fund credits have often been utilized to repay other creditors. In some cases, the resulting under-funding has led to increases in arrears (contrary to commitments to the IMF), followed by further complications, uncertainties and burdens on staff.

The deteriorating financing-adjustment balance further impinges on the cost-effectiveness of Africa's negotiations with its creditors by magnifying the disturbing effects of terms of trade and other exogenous shocks. Killick and Malik (1992, pp. 600-606) note that adverse external shocks are common among the reasons why governments turn to the IMF for balance-of-payments assistance and also note the frequency with which natural disasters are an important, sometimes dominant, factor in decisions to adopt a programme. Moreover, they (pp. 617-619) find the intrusion of unforeseen shocks a major reason for programme break-downs, which are associated with adverse terms of trade experiences.

This evidence suggests that international measures to protect debtor countries from the adverse effects of such shocks would both reduce the frequency of programme negotiation and help to keep existing programmes on course. Some steps have indeed been taken to extend the range of circumstances in which countries could take advantage of the IMF's long-standing Compensatory Financing Facility (now called the Compensatory and Contingency Financing Facility or CCFF).

However, at the same time decisions during the 1980s converted this from a more-or-less automatic fund for largely non-conditional assistance to countries experiencing temporary export shortfalls into a source of modest supplementary finance largely confined to countries that have already agreed a programme with the Fund. In effect, this has become a high-conditionality facility. Its procedures are cumbersome and demanding on debtor-country administrations, and the volume of compensatory finance it can offer is very limited. It is, moreover, expensive, bearing near-commercial interest rates, with no concessional provisions for low-income borrowers. And it requires borrowers to reduce their drawings of Fund credits, or add further to their reserves, in the event of favourable developments. As Polak has noted (1991, p. 11), provisions such as these make the CCFF unattractive to potential users and for such reasons it has been little used by African countries.

A related development is the more frequent inclusion in IMF programme stipulations of contingency provisions which increase the stringency of credit ceilings when *favourable* external developments occur, e.g. larger-than-forecast aid receipts. This provision is *asymmetrical*, however, for programmes also provide for larger increases in external reserves, *and therefore more stringent policies*, against the possibility of adverse shocks (Killick, 1992, p. 26).[17] Nothing could more strikingly demonstrate the retreat from the post-war consensus that has occurred in recent years. In consequence, governments enjoy little protection from the damage which can be done to their economies by unforeseen events over which they have no control, the necessity for negotiations is multiplied and the effectiveness of the resulting programmes is reduced.

B. *Conflicts of interest*

Various interest conflicts also reduce the cost-effectiveness of Africa's negotiations with its creditors. Among the most important of these are conflicts *among* creditors, which have a variety of adverse effects. In the case of the Paris Club the difficulties of securing collective agreement are well known, both as regards the general parameters of negotiation terms and their application to particular cases, leading Rieffel (1985, p. 18) to observe that discussions within creditor caucuses are sometimes more difficult and protracted than discussions with debtors.

Similarly, in the case of the London Club, Martin (1991, pp. 207) shows how the negotiations and their outcomes were designed to maximize solidarity (or minimize disagreement) among the banks, rather than to maximize the cost-effectiveness of the process. This was partly achieved by reliance on, and misuse of, suspect data and forecasts, and the cobbling together of "agreements" which ignored debtors' limited implementation capacities and which most of the negotiators knew were unviable. Even so, the difficulties of achieving agreement among the often large number of banks involved led to lengthy delays in the process.

Conflicts and competition among aid donors should also not be forgotten. Hewitt and Killick (1992, table 1 and *passim*) have shown large differences among bilateral donor objectives, and the literature is replete with examples of how competition among them gets in the way of effective aid coordination. As Whittington and Calhoun observed from their own experiences as aid workers, "all donors want to *co-ordinate*, but no-one wants to be *co-ordinated*" (1988, p. 307).[18]

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[17] Martin (1991, p. 84), cites the example of Zambia in 1986, when the IMF's own documentation showed that the Government had breached performance criteria only because of unforeseen developments, but recommended more cuts in budget expenditures and imports just the same.

These various conflicts, while they could be exploited by debtor-country negotiators, more often add to the costliness of the negotiation process and harden the terms on which agreement is possible. A case in point is the menu of options available in the Paris Club to creditor governments under the Toronto and post-Toronto terms. The necessity for this complicated arrangement arose because of the impossibility of securing agreement on a single set of terms. An example of the resulting complexities is provided by the United Republic of Tanzania's experiences, where Mgonja and Mlolwa (1991, p. 39) relate how, at the United Republic of Tanzania's Paris Club meeting in March 1990, three creditors selected the option of a one-third debt cancellation, three extended the maturity of their credits, while the rest opted for concessional interest rates, but with Japan choosing a combination of two of the options. Difficulties, stemming from creditor concerns about burden-sharing, also arise from the Paris Club's insistence that non-member creditors should not be given more favourable treatment than members - a stipulation which can cause difficulties in respect of credits from developing countries.

Inter-creditor conflicts also harden the terms offered to debtors because creditor caucuses tend to settle for a level of concessionality based, as Rieffel (1985, p. 18) observed for the Paris Club, on "the hardest position on each variable desired by any creditor" - a principle that has also operated in the London Club. Alternatively, it gives rise to a fudging of issues, in which laggard or unsympathetic creditors are permitted to insist on harder terms than those to which a creditor majority is agreeable. Thus, against the fiction that the Toronto terms menu options contain equivalent concessionality, the actual grant elements are estimated at 33, 0 and 22-27 per cent respectively for options A, B and C.[19]

Divisions *within* negotiating teams are another source of inefficiency. Among the creditors, there have been instances in the past of differences between Fund and Bank staff serving on the same team about such matters as the desirable levels of imports, government investment and domestic credit, although cooperation between them has improved in recent years. Disagreements and inter-agency rivalries occur amongst debtor teams too. Goreux (1993, p. 60) refers to poor coordination between the Ministry of Finance and Central Bank in Nigeria and Zambia as slowing down the workings of Paris Club procedures; Martin (1991, pp. 36-37) also refers to the adverse effects of divisions in these countries.

A final type of interest conflict which affects the cost-efficiency of outcomes is the more obvious one between creditor and debtor, and the fundamental asymmetry of bargaining power between them. To a greater or lesser degree, the debtors are in the position of having to accept whatever concessions are offered them on a take-it-or-leave-it basis. One of our respondents, for example, complains that, "In our experience, initial positions on "core issues" are seldom changed during the negotiation process, though other subsidiary areas are more open to discussion. These positions are not always well informed and, on occasions, the IMF do not seem to be well prepared." Martin (1991, pp. 42, 322), who has investigated the working of negotiation processes particularly closely, emphasises the essentially one-sided nature of the exercise:

> Even debtor-negotiators who were well prepared, united, flexible, experienced, persuasive, skilled in politics and economics, and who understood the Fund, received few concessions [from the IMF].
>
> Debt negotiations did not combine the values of all participants into a single jointly agreeable outcome ... To the extent that debtors were more dissatisfied by the outcome - though default would have been worse - outcomes and procedures were imposed. Sub-Saharan governments had only marginal influence. Creditors' superior power usually overruled debtor initiative, precedent and strategy.

This is a starker view than others have taken[20] but a further reminder of the unequal nature of the negotiations is provided by Elgström's

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[18] For a brief survey of the aid coordination situation in Africa see Killick (1991, pp. 42-44).

[19] Vourc'h (1992, p. 8). She goes on to estimate grant elements of 33, 23 and 22 per cent respectively if debtors stop paying after 10 years, and cites estimates by Debarle and Jacquier of actually negotiated outcomes, including the preferential rescheduling of aid loans, of 41, 9 and 23 per cent grant equivalents.

[20] Killick and Malik (1992, pp. 620-621), conclude from their survey of country studies (not confined to Africa) that it is easy to exaggerate the frequency with which programmes are dictated by the IMF to a reluctant but desperate government, which is not the typical situation.

(1992) study of aid negotiations between Sweden and the United Republic of Tanzania, an investigation which might have been expected to yield different results. Even though this relationship involved a sensitive, relatively altruistic donor agency with "an ideology of solidarity" and a "long and friendly history of Swedish-Tanzanian aid relations," the basic power asymmetry still asserted itself (p. 168):

> General power considerations coupled with the highly uneven organisational capacities seem to explain Sweden's almost total control of the agenda and other bargaining sub-processes. But we also have to take the attitudes of the Tanzanian negotiators into account. Had they been prepared to take more responsibility, norms encouraging such behaviour did exist - but the Tanzanian image of its role in aid negotiations did not allow for this possibility.

The point about this asymmetry, affecting all the classes of negotiations under consideration, is that there is no institutional provision for maximizing cost-effectiveness, least of all from the debtor viewpoint. It is scarcely surprising, therefore, if the processes and outcomes include avoidable costs, since they are principally intended to meet the objectives and stipulations of only one side of the negotiations.

C. *The absence of transparency*

To anticipate a theme that will be developed later, the costs of negotiation can be thought of as transactions costs, and the amount of these as a measure of the inefficiency of the process. Efficient transactions require a clear and widely-understood framework of rules, as well as some kind of enforcement authority. Without such transparency, one or more of the parties to a transaction will not have the information necessary to participate in a way that will clear the "market" efficiently and result in an outcome that maximizes the welfare of each party.

Partly because of the asymmetry of bargaining power mentioned earlier, many of the negotiations under examination here have been marked by a lack of transparency and this has been a source of the costs identified earlier. This can be illustrated in a number of ways. Martin (1991, pp. 110-114) is particularly scathing about this in connection with the Paris Club. While noting that some have claimed that Paris Club agreements were derived from a set of principles, he finds these to be ill-defined, often conflicting and inconsistently applied, and quotes a creditor-government official as saying that the "principles exist to justify the consensus" (p. 110). Martin goes on to state (p. 114):

> Fear of setting *precedents* on terms rarely constrained creditors. "Precedents" were defined by the lowest common denominator. Most were kept secret from debtors, to allow concessions for "favourites" without others citing them as precedents ... If a precedent became public, creditors argued that the debtor was a "special case." Hardline creditors often cited selected "precedents" to justify tougher terms ... Secrecy also allowed creditors to cite non-existent precedents to refuse concessions ...

There are particular problems with export credit agencies, which rightly regard themselves as being in competition and are therefore loath to divulge information about credits outstanding and payments on claims.

Martin is seemingly more positive about the London Club.

> The London Club was much less secretive than the Paris Club or IMF ... But they were secretive about factors in agreements, and approval or implementation problems: portraying procedure as rational kept down pressure for reform. Secrecy enabled banks to change procedure, "precedent" and "principle" to justify consensus or third-party pressure, making procedure and terms more inconsistent (p. 208).

The IMF, of course, is notoriously secretive, even though it has enunciated various principles for the design of its conditionality (including that of "uniformity of treatment" of its borrowing members). There is one respect in which its operations are particularly lacking in transparency. This relates to its use of waivers when governments contravene performance criteria. The limited evidence available indicates that the Fund has frequent recourse to these. Martin (1991, table 2.6) records that out of 95 programmes commenced in sub-Saharan African countries in 1980-1986 no fewer than 78 of these were subsequently the subject of waivers. He goes on (pp. 284-285) to report an even higher incidence of waivers in more recent programmes. Unfortunately, however, the Fund's policies and practices on waivers are shrouded in mystery.

It is unsatisfactory that this important aspect of the Fund's operations should so lack transparency, leaving governments uncertain where they stand and about the rules to which they are supposed to conform. These uncertainties are all the greater because readiness to grant waivers is used by the Fund as a policy instrument, as a tap to be turned down or opened wide according to its view of the *global* circumstances at the time.[21] The situation is made all the more unsatisfactory by the practice of the Fund of suspending access to a credit pending a decision on whether to grant a waiver and agreement on new performance criteria. This withdrawal of access, even if only temporary, can cause severe disruption to governments in often desperately tight payments situations, undermining the programme itself.[22]

One of the consequences (and intentions) of the absence of a strong basis of rules guiding negotiation outcomes is that creditor governments are thus provided with opportunities to give favoured debtor governments better treatment than others, in pursuit of creditor-country commercial, military or foreign policy objectives; hence the reference to "favourites" in the quote from Martin about the Paris Club above. The Fund's aspirations to uniformity of treatment notwithstanding, there is a well-documented history of such political favouritism in its lending decision-making procedures, chiefly at the behest of the United States and some other major-shareholder governments. From a survey of its dealings with 17 developing countries, Killick and Malik (1992, pp. 623-624) found that at least a third of them - probably more - had been able to negotiate relatively favourable programmes with the IMF because of special relationships with major-shareholder governments. Examples from Africa include Côte d'Ivoire, Gambia, Sudan and Zaire. While noting that it is difficult to judge the seriousness of this geopolitical interference, they concluded that it was among the strongest explanations for ineffective IMF programmes, and therefore for cost-inefficient negotiation processes. It is also clear that the absence of rules-based transparency complained of earlier has facilitated the supervention of geopolitical considerations in the outcomes of a substantial number of Paris Club and, to a lesser extent, London Club negotiations.

D. *The spread of conditionality*

The last decade has seen a veritable explosion of conditionality-induced policy changes in African countries. IMF balance-of-payments assistance has long been conditional on government commitments to certain macroeconomic policy measures but more recently other agencies have boarded this bandwagon. So far as government policy advisers and administrators are concerned, this has enormously increased the volume of work.

By far the most important development has been the movement of the World Bank since 1980 into "policy-related" lending. Bank data (1992a, table A1.2) show the annual average of adjustment-related loans in Africa to have increased from three in 1980-1982, involving $190 million, to 15 in 1991, involving nine times as much ($1,732 million). Its "structural adjustment" conditionality has always been wide-ranging, and the staff's tendency to be over-ambitious in programme designs has been a constant criticism in internal Bank evaluations of its adjustment lending. This self-criticism has not, however, prevented further proliferation of policy conditions. The latest Bank evaluation (1992a, table A2.3) gives the following information concerning the average number of conditions per adjustment loan:

	1980-1988	*1989-1991*
Preconditions (prior actions)	9	18
Legal requirements [a]	12	17
Other policy commitments	18	21
Total	39	56

[a] Legal in the sense that their observance is required if a loan tranche is to be released, i.e. similar in status to IMF performance criteria.

A specific but, we believe, representative illustration is provided by a Bank report on Uganda, a country still trying to rebuild its public administration after the ravages of prolonged civil war. This sets out a total of *86* specific policy commitments for 1991/92 to 1993/94, of which *79* should have been undertaken or initiated in FY 1991/92 alone.[23]

Where the IFIs have led the way bilateral donors have, in varying degrees, followed.[24] It is increasingly common for the granting or disbursement of bilateral aid to be made conditional on continued compliance with IFI conditionality, but several donors have not stopped there. There have been a number of well-known cases where donors have stipulated *political* reforms in the directions of improved observance of human rights, reduced military spending, accountability and democratization. A number of donors (including Germany, the Netherlands and the United States) have also widened the net of policy conditionality, going beyond the IFIs in their insistence on measures for environmental protection, poverty reduction, enhancement of the role of women and private enterprise development. Some have further attached conditions to the ways in which governments use counterpart funds generated by programme support. Maxwell (1992, p. 3) has written of a litany of complaints concerning the operation of this form of conditionality and of recipient "bewilderment in the face of complex, time-consuming and diverse donor accounting procedures."[25]

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[21] See Killick (ed.) (1984, p. 212), for documentation on how government access to waivers was consciously reduced in the early 1980s as part of a general toughening-up of conditionality.

[22] See Martin (1991, chap. 2), for evidence.

[23] From an unpublished World Bank Special Program of Assistance status report on Uganda, February 1992.

[24] For a recent survey of bilateral donor conditionality see Hewitt and Killick (1992).

At the same time as the number of agencies laying down policy conditions has been increasing, there has also been a tendency within the IFIs to add to the number of conditions, despite protestations of their desire to avoid this. We have already noted this trend in the World Bank. In the IMF, this tendency is most obvious in the case of its ESAF programmes - the facility most commonly used in Africa. The range of policy conditions is considerably wider in these programmes than it is in traditional stand-bys, although some proliferation has also occurred within stand-bys.[26] There has been extensive use of preconditions in SAF/ESAF programmes but the starkest evidence on the proliferation of conditionality is provided by the following averages for the number of performance criteria per programme:[27] 1968-1977 - below six; 1974-1984 - seven; 1984-1987 - nine-and-a-half. In 1979 conditionality guidelines were agreed by the Fund's Board intended to limit the number of performance criteria but this attempt to turn back the tide was evidently unsuccessful.

A principal reason for this is that, even in stand-bys, Fund conditionality now goes beyond its traditional demand-management concentration to stipulate supply-side measures, e.g. as regards trade liberalization, pricing policies or privatization. Under pressure from some members of its Board, the Fund has also begun to take a more active interest in the impact of its programmes on vulnerable groups, including spending on social welfare programmes. It has even been pushed in the direction of adding environmental provisions, although this has probably not amounted to much in practice.

There have also been important changes with respect to the Fund's thinking on fiscal conditionality.[28] Internal staff papers now write disparagingly of the past tendency of programmes to go for "quick fixes" and to over-concentrate on aggregate spending ceilings. A number of influences pushed the Fund in this direction. Governments became increasingly canny in evading overall spending ceilings, and it was difficult for Fund missions, for all their experience, to compensate for informational asymmetries and close all possible loopholes. Secondly, the Fund came to appreciate more that the way in which the burden of cuts is spread across the government's expenditures strongly affects their impact on the economy. The government may, for example, be tempted to impose disproportionate reductions in the provision of economic services in attempts to avoid reducing the size of the civil service or to protect the defence budget, but Fund missions no longer treat these topics as taboo. Detailed attention is now paid to improving the content of government expenditures,[29] as well as to tax reforms and other revenue-raising measures.

Quite apart from questions about the merits of its policy stipulations, this proliferation (or "deepening", as Fund staff describe it) is an obvious problem for implementing governments, increasing the already formidable pressures on the cadre of key administrators and increasing the probability of slippage in programme execution. The particularly stringent degree of conditionality attached to ESAF programmes has also had a deterrent effect on the utilization of this facility, the demand for which has been well below expectations. As Feinberg (1991, p. 6) ironically observed, "When the ESAF was initiated, Fund management emphasized that the resources would only be used to support strong adjustment programmes. Evidently the Fund has honoured this commitment".

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[25] On this subject see the special issue of the *IDS Bulletin*, vol. 23, No. 2, April 1992.

[26] The following paragraphs are drawn from Killick (1992), *passim*.

[27] From Polak (1991, p. 14). The overlap in the first two periods is presumably because the data are taken from staff studies which contained these overlapping periods.

[28] See Tanzi (1989), on which the following paragraphs are based.

[29] The earlier Fund position that it was up to governments to decide how to implement overall cuts has always been fairly extensively honoured in the breach, however, so we are describing a shift of emphasis rather than a complete turnaround. Thus, the Deputy Director of the Fund's Africa Department until 1987 wrote that, after negotiating an overall expenditure cut, a Fund mission "has to discuss with the authorities how to implement this cut by analysing the budget line by line" (Goreux, 1989, p. 143). See also Killick (ed.) (1984, p. 190).

If we take all its aspects together, this conditionality explosion seriously affects the cost-effectiveness of the negotiation processes reviewed here. Most obviously, it increases the information and opportunity costs described in section I. The ever-growing influence of external agencies in socio-economic policies, to say nothing of political processes, also increases the uncertainties faced by investors and other economic agents about the future policy environment and the sustainability of the reform process.

The conditionality explosion has further adverse effects on cost-effectiveness. For one thing, it has increased demands on the IFIs, as well as on recipient administrations, not least because of the additional need for coordination among them, and with other donors. At the same time there has been strong resistance on the Executive Board to staff recruitment in line with the growth of conditionality-related work, leading in some cases to excessive workloads.

An almost inevitable result, reinforced by a desire to achieve comparability of treatment across countries, is to resort to a more or less standard approach to programme design. That it applies a uniform prescription has long been a complaint about the IMF. Even though there is evidence that Bank programmes are more tailored to country circumstances, there are limits to the Bank's flexibility too. In both cases, the large number and ambitious scope of country programmes add to inbuilt pressures for the adoption of standard recipes. Pressure of work and the inherent limitations on the expertise and freedom of action of the IFIs increase the difficulties of coping with the complexities and uncertainties of devising tailor-made adjustment packages. Martin (1991, p. 35) has observed the consequences of these tendencies in African countries:

> IMF staff were overworked, especially because they had to reconcile positions with the World Bank and take account of creditor-government pressure. A larger number of African countries were applying for loans more often ...; and conditions were proliferating, demanding new expertise ... Time pressure, notably in functional departments, often meant that staff did not understand the country's economy or politics, or had not enough experience of African adjustment to be flexible. They tended to absorb the Fund's view of the country in the briefing paper.

This combination of circumstances, in which the IFIs are less well able to tailor policy conditions to individual country conditions, and recipient governments are swamped by the conditionality of these and other agencies, reduces the possibility that governments will be able to contribute their own policy proposals and persuade lenders of their adequacy. Hence programmes tend to be prepared in Washington (or other donor capitals), weakening government identification with the measures to be undertaken (the government's sense of programme "ownership" in Bank parlance). This, in turn, reduces the likelihood of programme implementation, as a report by the Bank's Evaluations Department (World Bank, 1992b, chap. 10 and annex 8) has recently confirmed. This tested for correlation between indicators of ownership and the Bank's assessment of the satisfactoriness of programme outcomes. The results were strong and confirmed by statistical significance tests: ownership was high in most programmes achieving good results and low in ineffective programmes. Borrower ownership was strongly predictive of programme success in three quarters (73 per cent) of all cases, and most of the "deviant" cases could be explained by the supervention of exogenous shocks.

In brief, then, the conditionality explosion of the last decade can be seen as undermining cost-effectiveness by swamping national policy advisers, increasing the danger of programmes inappropriate to local circumstances because they are donor-designed, and reducing the extent of implementation.

E. Recent improvements

Having written at some length about the evidence for high costs and sub-optimal effectiveness, and some of the reasons for this, it is important to appreciate that the last few years have brought substantial improvements. Much of this change is attributable to the adoption of more realistic (i.e. concessional) debt rescheduling arrangements by the Paris Club creditors, under the (1988) Toronto and (1991) "enhanced-Toronto" terms. By comparison with previous policies, these new terms incorporate important improvements from the point of view of the low-income debtor countries eligible for these terms:[30]

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[30] For a useful account of these changes and a statement of the current situation, see appendix II of the *World Debt Tables, 1992-93* (World Bank, 1992c). See also Goreux (1993) and Vourc'h (1992) for extended discussions of these terms.

- Adoption of a menu approach in order to accommodate different creditor policies and constraints.
- Application of sub-market moratorium interest rates on rescheduled non-concessional debt.
- Greatly much extended repayment periods for rescheduled debt.
- The prospect, subject to an initial three-year "probationary period", of cancellation or restructuring of the entire outstanding stock of debt. This provision is potentially the most important change of all because of the way it would increase the amount of debt relief available.

Additionally, a high proportion of aid debt owed by low-income African countries has been cancelled, leaving commercial loans covered by export credit agencies as the main category of outstanding debt coming under the Paris Club umbrella.[31] Moreover, adoption of these terms has enhanced transparency and reduced negotiation costs by increasing the uniformity with which eligible debtors are treated. It has also diminished the substantive content of consequential bilateral negotiations, particularly as they concern the moratorium interest rate. This move towards greater transparency (implying less geopolitical interference in negotiation processes) has been further aided by the end of the Cold War and reduced Great Power interest in former client States.

The availability of technical assistance (and computerized data management systems) for the provision of expertise on debt matters and associated adjustment programmes has also improved over time, but a high proportion of this appears to be of low efficacy. The World Bank (1992b, box 11.1) assesses that under 20 per cent of its adjustment-related technical assistance to sub-Saharan African countries is "substantially effective", 15 per cent having a negligible impact and the remaining 65 per cent being only "partially effective". This was a considerably worse outcome than for similar assistance in other regions.

There have been important changes in the London Club too.[32] The most important influence has been the 1989 Brady Initiative to provide public financial support for debt and debt-servicing reduction agreements between commercial banks and middle-income debtor countries. Nigeria is the only African country to have benefited directly from this Initiative. In 1992 it negotiated a $3.3 billion debt buy-back with a 60 per cent discount and a further $2.0 billion of service reduction through the acquisition of interest-reduction bonds, although no IFI or other new money was provided in this case. The Initiative inspired the creation of a Debt Reduction Facility by the World Bank in 1989, designed specifically for low-income debtor-countries. Although take-up of this facility has been retarded by the complexity of the negotiation process among other reasons, Mozambique and Niger have used it to buy back most of their commercial bank debt, and Uganda is apparently on the brink of completely extinguishing such debt by this means.

Various debt-swap arrangements have also been developed, although only a handful of African Governments have utilized these, in agreements involving only small amounts of debt. Finally, it appears that the use of steering committees representative of all a country's creditor banks has become more effective for speeding-up negotiations by comparison with earlier procedures.

There have also been improvements in the design and funding of adjustment programmes and in matters affecting the quality of development assistance. One example of this was a more imaginative approach to contingency provisions by the IMF in its 1989-1990 programme with Zambia, which took a deliberately pessimistic view of likely copper export prices and allowed part of excess export receipts to be used to make good shortfalls in supporting finance.[33] The IMF's shift into "structural" programmes through the vehicles of the SAF and ESAF introduced a potentially important modification to programme formulation and negotiation processes. SAF and ESAF programmes are based on three-year Policy Framework Papers (PFPs), intended to be drafted jointly by the borrowing government, the IMF and the World Bank. It is widely accepted that in the early years of this innovation the role of the government was often minimal, with the PFPs written in Washington by Fund and Bank staff. A former senior member of the Fund's staff dealing with Africa admitted as much, in writing of the mid- and later-1980s: "Unfortunately the PFP so far has been primarily a subject of negotiation between the staffs of the Fund and the Bank ..." (Goreux, 1989, p. 162).

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[31] The World Bank (1990, annex D.2), records that a total of $5.7 billion of the aid debt of 23 African Governments was cancelled in 1988-1990, although it does not state how much this still leaves outstanding.

[32] On this point see World Bank (1992c, appendix III).

[33] The example is from Martin, Mistry *et al.* (1991, p. 97): "The balance of payments [projection] was based on a price of US $0.86 per pound for copper exports. This was well below prevailing and expected export prices. Excess copper earnings due to price were therefore expected. This would be used first to maintain imports by offsetting any shortfall in external finance - significantly, measured by net finance programmed to fill the current account deficit excluding grants and interest. Any additional excess was to be allocated: 30 % to reduce external finance needs, 10 % to increase reserves/debt service/imports at government discretion, and 60 % to gross reserves ..."

However, it appears that this situation has gradually improved so that borrowing governments have acquired more of a voice in the process. And to counter the long-standing criticism that IMF missions largely confine their discussions to the Finance Ministry and Central Bank there has been an effort to involve a wider range of ministries in the preparation of these documents, including line ministries which must implement the adjustment measures. In consequence, the Fund is on record as believing that the PFP process, "has become an increasingly effective instrument for designing medium-term policy measures" (*Annual Report, 1991*, p. 57), although there are doubtless a good many governments which still see the PFP as essentially a "Washington" document. Moreover, the PFP still retains some of the other disadvantages pointed out by Goreux, principally that they involve the preparation of three related but different documents and three separate negotiations.

The Special Program of Assistance (for Africa) launched under the auspices of the World Bank in late 1987 has also been playing an increasingly important role in raising the cost-effectiveness of debt and aid negotiations. The SPA establishes a minimum level of concessionality in the contributions which donors make to it, i.e. a grant element of at least 80 per cent. It has provided a mechanism of aid coordination and introduced co-financing arrangements to safeguard against the underfunding of programmes, although the Bank has been embarrassed by the low volume of response to this provision. With some effect, it has worked to secure voluntary improvements in the quality of aid provided. A 1990 report on the SPA summarizes some of its key provisions (World Bank, 1990, p. 20):

> The SPA program has helped strengthen institutional mechanisms, many of them informal, to improve the quality and administration of adjustment assistance. In particular, the SPA established: quarterly and semi-annual reporting on the allocation and disbursement of pledges to recipients; semi-annual plenary meetings to discuss country eligibility and to monitor progress on meeting financial gaps; special meetings on selected countries to review their adjustment performance; more frequent working-level contacts and exchanges of documents; and a forum for addressing selected issues linked to better delivery of adjustment assistance, particularly untying of assistance and standardization of procurement and disbursement procedures.

As an example of progress achieved, its arrangements have succeeded in persuading a number of participating donors to end or reduce the requirements for procurement tying so that, as of early 1991 about 85 per cent of SPA financing was broadly untied.[34] The SPA also appears to have been rather successful in raising the volume of adjustment support available to eligible members, so that Martin (1991, p. 317) - by no means an uncritical observer - reports that in 1987-1990 the SPA "gradually filled the financing needs of most [eligible] countries".

There has also been a widely-observed improvement in the workings of Consultative Groups and comparable aid coordination forums. By common consent, the preparation of both sides for these meetings has improved and they now work more efficiently, even though there is also agreement that much room still remains for further improvement.[35]

F. *Summing up the current situation*

Where do these improvements leave us? We suggested in section I that the various negotiation processes in which African Governments are involved are subject to substantial costs. Probably the chief of these are the opportunity costs resulting from the large demands made by multiple and complex negotiations upon the key cadre of officials dealing with the design and management of economic policy. There are also, we suggested, substantial information costs, although these have diminished over time and much of the information secured as a result is of genuine value. There are also financial costs arising from various delays; and investor risks arising from uncertainties generated by frequent policy changes, incomplete implementation and doubts about the political sustainability of adjustment.

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[34] From an unpublished World Bank paper of February 1991.

[35] See, for example, Panday and Williams' 1990 report prepared for the Second United Nations Conference on the Least Developed Countries (p. 42): "Generally, preparation for and specific conduct of CGs and RTMs have greatly improved. Both the UNDP and the World Bank have upgraded their performance in this respect ...," although they go on to point out continuing areas of weakness. Martin, Mistry *et al.* (1991, p. 104) similarly refer to preparation for CGs by African Governments as having "vastly improved" during the 1980s.

We suggested also that there were good reasons for doubting the effectiveness of the processes put in place. Through most of the 1980s, debt reschedulings in the Paris and London Clubs were manifestly inappropriate for the economic situations and prospects of most African debtor countries. The short-term nature of reschedulings maximized the costs involved, while offering only the most temporary financial benefit to debtor governments. We also pointed out evidence calling into question the effectiveness of the Fund and Bank adjustment programmes that have so multiplied in the last decade, in terms of incomplete implementation and the revealed limitations of the programmes' capacity to achieve their objectives. Finally, we have drawn attention to various factors reducing the quality of bilateral development assistance, including procurement tying and weak aid coordination, leading to an unmanageable proliferation of negotiations, programmes and projects.

A number of sources of the sub-optimalities just summarized were suggested. One was the retreat in the 1980s from international cooperation and the resulting shift of the costs of international economic instability on to debtor countries. This deterioration in the balance between financing and adjustment has resulted in the manipulation of negotiation procedures to understate deficit countries' financing needs, insistence on unrealistic programmes and the underfunding of adjustment programmes. The associated retreat from contingency financing has also left deficit countries more exposed to exogenous shocks, adding to the frequency with which they need recourse to negotiation and pushing agreed programmes off course.

Interest conflicts among creditor countries, and between them and debtor countries, have also taken their toll, resulting in preoccupation with burden-sharing and "lowest common denominator" outcomes. Most fundamentally of all, we have drawn attention to the basic asymmetry of power in the negotiations under review here. In the absence of effective institutional safeguards against it, this has the consequence of allowing creditor interests to insist upon terms which are not cost-effective when seen from a global viewpoint. It has also allowed a denial of transparent, rules-based processes, paving the way for the unequal treatment of like cases, often in pursuit of creditor countries' commercial and foreign policy objectives. This, in turn, has increased transactions costs and the frequency of ineffective, politically-motivated adjustment programmes.

Lastly, we stressed the adverse effects of the conditionality explosion of the last decade. Besides adding to the burden of work in debtor countries, and the related information and opportunity costs, this has also increased pressures for "off-the-peg" IFI programmes which are not best designed to fit local circumstances and has weakened borrowing governments' ownership of agreed adjustment programmes - both factors which weaken programme implementation and the cost-effectiveness of the process. It has also heightened the risks for investors arising from uncertainties about policies and their sustainability.

The improvements described in the last subsection need to be seen against this background. The changes have undoubtedly increased the financial benefits derived by African countries from Paris and London Club negotiations, increasing the viability of the process and in some measure reducing uncertainties. The Toronto and post-Toronto terms have also increased transparency by more precisely defining the terms which creditors must offer in bilateral negotiations. The SPA appears to have been quite effective in mobilizing additional finance (including aid debt write-offs) for eligible countries, and in improving the coordination and quality of aid. The PFP framework is apparently working better as a mechanism for increasing the say of governments in programme design, and for aid coordination, in which task Consultative Groups reportedly have also increased their effectiveness.

These are genuine gains, reflecting a more realistic creditor's view of Africa's economic situation. At the same time, they do no more than make a beginning with removing the above-mentioned obstacles to improved cost-effectiveness. As various creditor governments have realised, even the post-Toronto terms provide inadequate debt relief, with further progress obstructed by the lowest-common-denominator factor. The conditionality explosion is intensifying rather than abating, as is the frequency of IMF programme break-down. And not all African countries have been able to take advantage of the improvements that have been achieved, depending on the eligibility criteria in operation.

In short, there remains much scope for improvement, so we turn now to consider ideas for moving things forward.

III. Responding to the remaining weaknesses

A. The gap in the system

The thrust of what follows is concerned with the inefficiency of present arrangements and the need to strengthen the incentive structures for securing improvements. Present inefficiencies are illustrated by a number of the features already discussed.

The history of approaches to the debt problem offers one example. From 1982-1988 the creditor interests insisted on terms in the Paris and London Clubs that were seen, almost universally from the outside and widely even among creditor participants, as unrealistic and therefore unviable, quite apart from the human costs involved.[36] Yet all sides devoted considerable manpower to the negotiation of these agreements, and the IMF and others used substantial financial resources to support programmes and agreements that were either doomed from the start or could provide only short-term palliatives. The defence could not be used regarding low-income African debtors, as it was in Latin America that the early approaches at least shored up an international banking system that would otherwise have been at risk, for neither in size nor nature did the African debt problem pose that kind of risk.

When finally the nettle of past failure was grasped, at Toronto and subsequently, the measures that could be agreed among the creditors were a classic example of too little too late, so that today "everyone knows" that the recalcitrant creditors will sooner or later have to agree additional concessions if a viable solution is to be found.[37] In the meantime, there will be more failed programmes, more wasted resources and further avoidable hardships. While a creditor may believe that it can defend its interests by holding out against concessions, the question assumes a different form when viewed collectively.

The conditionality explosion illustrates the same divergence between individual and collective interests. From the perspective of any one donor agency, or professional interest group within an agency, it may seem to make sense to insist on some policy condition in negotiations with a debtor government. But as each agency that decides on this must also develop its own conditionality, each new extension of IFI conditionality and every additional demand on overloaded debtor government administrations will reduce the probability that each conditionality will be observed, leading again to a mis-application of human and financial resources.

The retreat from the financing of external shocks and the introduction of asymmetrical contingency provisions, described earlier, provides a further example of inefficiency. In terms of global output, employment and trade, a policy of requiring deficit countries to deflate in the face of natural disasters or other shocks cannot be justified in economic terms, to say nothing of the human welfare implications of transferring the costs of these shocks to already desperately poor people. Viewed collectively, it is an irrational response, although that is not how it looks to an individual creditor.

To illuminate this familiar and intractable problem, we can draw an analogy between the processes surveyed in this paper and the concept of transactions costs. Such costs can be considered a kind of market failure in that they are absent in perfectly-operating markets. Transactions costs include the costs of information, risk, monitoring and policing associated with contract negotiation and enforcement. They arise, among other reasons, because impersonal market processes and the complexities of modern economic life throw up opportunities for anti-social economic behaviour and hence the necessity to create a concomitant network of institutional structures to promote the collective, public interest over the interests of the "free rider" and the dishonest. By definition, such structures need to be independent of particular interests; within national economies we normally look to the State to perform this role.

We can view the negotiation costs surveyed here and the sub-optimal effectiveness of the solutions put in place as transactions costs and as evidence of a kind of market failure. If we do so, we can see the essence of any systemic reform as requiring the establishment of institutional arrangements to minimize the transactions costs of debtor-creditor negotiations, and to safeguard collective over individual interests. In reviewing his evidence on IMF, Paris Club and London Club negotiations, Martin (1991, p. 321) puts his finger on this weakness of present arrangements:

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[36] For evidence of widespread realization of the unviability of past approaches, see the conference proceedings in Lancaster and Williamson (1986). For support for the statement that many creditor participants did not believe in the sustainability of their approach, see Martin (1991, chaps. 3 and 4).

[37] See Abbate and Tran-Nguyen (1992), who show that even full application of the original Trinidad proposals would not have resolved the debt problems of a number of African countries.

> Participants did not search for economically optimal results for the debtor. An objective view of each economy was not the main influence on the form or amount of adjustment ... Nor did it determine finance - as the "adjustment gap" calculation, its lack of influence on creditors unless it suited them, and the inadequate levels of contingency finance make clear. Global economic "mutual interest" or "interdependence" had almost no influence - except in protecting the international financial system - which meant priority of bank over exporter interests.

B. Strengthening the institutional base

A number of attempts have been made to fill this institutional vacuum. The most ambitious was the creation in the early 1960s of UNCTAD, intended precisely to create a new, independent negotiating forum for the resolution of North-South differences in the areas of trade and finance. Sadly, this agency has lost influence among creditor governments in the last few years.

Both the IMF, which likes to present itself as a cooperative organization, and the World Bank, which has introduced a number of innovations in this field, would also claim to be guardians of the international interest, vis-à-vis particular interests. Both indeed attempt to play such a role, occasionally taking positions that are unpopular with creditor interests. But both are severely constrained in their ability to act independently. Both need to pay particular attention to their major shareholders, with successive United States administrations having a disproportionately influential voice on the councils of each. In varying degrees, both are too identified with creditor interests to have a strong claim to be independent arbiters of collective global interests in debt and aid negotiations.

Each, none the less, has made contributions to filling the institutional vacuum. In the case of the IMF, its actions in the 1980s to pressurize commercial banks to provide "new money" (or at least to slow down the rate at which they were reducing their exposures) for heavily indebted countries undertaking adjustment programmes effectively asserted an international interest. Our earlier (II, E) description of the ways in which the SPA has sought to strengthen institutional provisions provides another example of a constructive IFI intervention: acting to secure collective donor agreement on measures to increase the volume and improve the quality of aid that would not have been forthcoming if left to individual agencies.

On a more global basis, the work of the OECD Development Assistance Committee (DAC) can similarly be seen as helping to fill the institutional gap, in its efforts to improve donor coordination and the quality of their aid, and to minimize the deleterious effects of inter-agency competition in the provision of export and mixed credits, although to the outsider the results of its work appear to be only incremental. The creation of the Paris and London Clubs can also be understood as *ad hoc* responses to creditor perceptions of the inadequacies of existing arrangements.

These Clubs, of course, are overtly representative of creditor interests, just as the DAC is a creature of the donors. In a sense, they are useful *because* they have little independence: creditors-donors are willing to place a degree of trust in them because there is no question of their opposing the interests they represent even though their recommendations are not always welcome to individual creditors or donors. This contrasts, say, with the position of UNCTAD, which, rightly or wrongly, came to be identified with debtor interests. It also explains creditor reluctance to make use of independent mediators in seeking to reconcile differences between creditor and debtor positions. Thus, Martin (1991, p. 42), referring to negotiations with the IMF, stated:

> ... *advisory groups* of economic experts for debtor governments had only limited success when they tried to mediate on behalf of Tanzania in 1981-2 and Uganda in 1986-7. They often convinced debtor governments that policy change was needed, but had no leverage to ensure compromise by the Fund, which usually dismissed their ideas. However, they did influence [World] Bank policy, and when the Fund and Bank wanted to compromise, as for Tanzania in 1986, some ideas were revived.

The essence of the difficulty about establishing an effective independent institution that would speak for the international interest in the creation of cost-effective negotiation processes is that it clashes with the reality of the one-sided distribution of negotiating power between creditors and debtors underscored in Elgström's study of aid negotiations. To be realistic, proposals to strengthen existing institutional provisions have to acknowledge this fundamental asymmetry, even though it is important to reform some of the consequences of creditors' dominant power. Creditor interests, broadly understood, must be convinced of the desirability of change. There has to be a consensus on this.

This suggests that any breakthrough is most likely to occur at the political level. In the context of raising the cost-efficiency of development assistance to Africa, this author has already argued the case for a new political beginning (Killick, 1991, p. 49):

> ... with the ending of the Cold War and consequential reductions in the importance of security-cum-foreign-policy considerations, more progress might now be possible. The politics of the situation is thus the key, among both donors and recipients. If there is to be a fresh start, it is at the political level that it will have to be initiated. The beginning of the 1990s is a good time to attempt a fresh start. We have already referred to policy improvements and political stirrings within Africa; and to the radical re-evaluations of security and foreign policies now under way among donor countries. Both developments will create new policy priorities which may permit some of the old obstacles to aid effectiveness to be overcome. At the same time, the latest World Bank report on SSA has led to the creation, at the initiative of the Netherlands government, of a "Global Coalition" for Africa [GCA] intended to provide a new type of forum at which mutual difficulties can be frankly discussed. To engineer the new beginning in effective aid called for here should be the priority agenda item for this Coalition.

This proposal is pertinent to the rather wider range of issues considered in this paper. The GCA appears to have made a promising beginning in its work. It offers a new type of forum which operates through consensus-building and apparently has the confidence of creditor and debtor countries.

If it were possible to achieve a political consensus on the desirability of changes to increase the cost-effectiveness of present negotiation processes, what kind of institutional framework might be established? While there would be a natural inclination for *ad hoc* responses, the processes reviewed in this paper are so closely interconnected that it is important to take an overall, or systemic, view of assistance to debtor countries.

A number of suggestions have been made. Williamson (1992, pp. 93-95) has argued strongly for the creation of a Debt Restructuring Agency which would have some of the features envisaged above. Lancaster (1991) proposed the creation of Adjustment Review Consortia which could be a valuable basis for discussions, and Martin (1991, pp. 326-329) makes suggestions along similar lines. Under these proposals, aid and debt relief negotiations would be merged into a single process, combining the subject-matter of the present Paris Club and Consultative Group (and similar) negotiations. This would be intended both to reduce the burdens on debtor-government administrations described earlier and to increase the incentives for implementation of adjustment programmes, thus addressing the sub-optimality of both the costs and effectiveness of the present situation. Such Consortia could also provide a forum in which IFIs and bilateral agencies collectively agree to limit the coverage of their conditionality to a manageable number of priority items, as well, perhaps, as taking over the institutional functions of the SPA. It would be important that the Chairpersons of such Consortia should be able to take an independent stance as occasion demands rather than being perceived as the mouthpiece of creditor interests, and that they should have the resources to be able to call upon the advice of independent advisers and mediators when needed.

C. *The tasks*

If such arrangements could be established, what would be their priority tasks? One would be to simplify some of the present complexities, thereby lowering the associated costs. The idea of "one-stop" negotiations is an attractive one to work towards but meanwhile there are a number of things that could be done to reduce present complexities. One possibility would be to combine Paris Club proceedings and at least some of the subsequent bilateral negotiations into a single meeting, given the progress that has been made under the menu approach in specifying the terms which creditor governments may offer.

The mandatory consolidation or writing-off of small debts (some of which are as small as $100) would also be desirable if the Paris Club could agree to this (Goreux, 1993, p. 69). Another desirable simplification would be greater harmonization of aid donor reporting and accounting procedures in order to reduce the large volume of work created for recipients by the idiosyncrasies of each agency's requirements.[38] It would further be desirable to bring within the aegis of Paris Club agreements creditors from former communist countries, from OPEC and from other developing countries who have so far chosen to remain outside. Another suggestion that should be taken up is for the creation of joint pre-negotiation teams to prepare agreed data on debt and other economic variables, and perhaps consensual analyses of the situations revealed and projections of likely future developments.[39]

Lack of transparency in the processes was one of the deficiencies in the negotiation processes identified earlier, particularly the unequal treatment of comparable cases because of political favouritism. It is difficult to offer a systemic solution to this problem, since it depends essentially on the self-restraint of the governments of powerful creditor countries. However, one aspect of inadequate transparency that may be less intractable is the absence of public criteria determining IMF decisions on the granting of waivers. These would have to be framed so as to avoid placing the Fund in a straitjacket and allow sufficient flexibility to accommodate particular country circumstances, but it adds to the costliness of the present system that governments do not know the rules governing this important aspect of Fund policy. For the same reasons, it would also be desirable to further increase the transparency of the principles under which Paris and London Club settlements are designed, and the criteria that are applied.

Another crucial factor identified earlier as reducing the cost-effectiveness of present arrangements was the shift that has occurred away from the financing of temporary disturbances in favour of requiring deficit countries to adjust even to these. There are two particular aspects which suggest themselves for priority attention. The first is the restoration, with adequate resources (concessional, where necessary), of the IMF's CCFF as a facility to be drawn upon automatically in times of unforeseen need and without stringent policy conditionality.[40] A related change would be in contingency provisioning in IMF programmes to make this more symmetrical, so that programme provisions are relaxed, or supporting finance is increased, in the event of adverse unforeseen shocks. That such action is possible is demonstrated by the Zambian example given earlier, and there is also a precedent from Mexico.[41]

Improved contingency financing would raise the cost-effectiveness of negotiation processes by reducing the number of occasions when governments need to resort to adjustment negotiations and, in particular, by reducing the large number of programmes knocked off course by unforeseen shocks. However, even this would still leave the danger of programme underfunding because the total volume of supporting finance is inadequate. In this connection, it goes without saying that, subject to whatever new institutional arrangements might be introduced, the present work of the SPA in mobilizing additional funds and co-financing should be continued, and that the SPA itself should remain in existence so long as there is a need for it.

The same can be said of the IMF's ESAF facility. Despite its faults, including conditionality so stringent as to discourage use of this facility, ESAF has proved a valuable vehicle for the provision of concessional finance in support of medium-term programmes that go beyond conventional demand management to address structural weaknesses underlying the payments problems of most African countries.[42] The present ESAF arrangements have been extended until late 1993 but there is as yet no commitment to continuing with something similar thereafter. It is most important that its value should be recognized and that similar provisions should be continued well into the 1990s.

It is also important that those creditors who recognize that the present "enhanced Toronto" terms of debt relief still do not go far enough should continue to press for a further liberalization of terms, and that other creditors should not be allowed to undermine the value of the concessions made through misuse of the menu system to pretend a fictional burden-sharing parity.

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[38] Riley (1992, pp. 44-45), reports on an attempt through its Consultative Group of achieving harmonization between donors on counterpart fund accounting requirements for Mozambique, although it appears that only limited progress has so far been achieved.

[39] See Martin, Mistry *et al.* (1991, chap. 9 and *passim*), for a fuller statement of proposals along these lines.

[40] It should be noted, however, that this facility would not be able to compensate for revenue losses associated with long-term deteriorations in the terms of trade as distinct from temporary falls below export price trend lines.

[41] Note that the Fund has done this in particularly favoured cases. A stand-by programme negotiated with Mexico in 1986 is of special interest in this connection because it contained provisions that varied the terms of the programme depending on external trading and other conditions, with automatic modification of both performance criteria and of the amount of the credit according to the value of petroleum export earnings and the growth of the economy. Mexico, however, was treated as a special case, and a further example of the unequal treatment of deficit countries.

[42] See Killick (1992), for a more extended discussion of the ESAF.

Questions of debtor eligibility for favourable treatment should also be tackled in a more satisfactory manner. This has been a particularly contentious issue in the SPA, where donors have sought to restrict the list of eligible countries so as to limit the resulting claims on financial resources.[43] In consequence, a substantial number of African countries have remained outside the SPA net; a smaller, but still significant, number (including Cameroon, Côte d'Ivoire and Nigeria) have also fallen outside the Toronto terms. It is naturally right that scarce concessional resources should not be extended to countries that can afford to do without them. On the other hand, the exclusion of some of these countries is a consequence either of the overvaluation of their currencies (overstating per capita incomes in dollar terms) or of the donor-creditor pressures just mentioned, with Nigeria particularly at risk because of its large size.

The governments of the debtor countries can also play their part in increasing the cost-effectiveness of negotiations by paying due attention to the value of building up and maintaining an adequate data base on the public debt and other economic statistics; by utilizing and maintaining the computerized data management systems that are now readily available from the Commonwealth Secretariat, Canada's IDRC, UNCTAD and the World Bank, and which are invaluable tools in debt negotiations, but, when established, are too often allowed to fall into disuse; by building up an experienced cadre of technical staff and giving them incentives to prevent excessive turnover; and by playing the lead role which is so essential in donor coordination.[44]

Lastly, it should be added that the reports by Goreux (1993), Martin, Mistry *et al.* (1991) and Panday and Williams (1990) contain a host of more specific recommendations on such matters as debt statistics, the strengthening of local staff capabilities and utilization of technical assistance, the detailed implementation of Paris Club agreements, the calculation of financing gaps, and the coordination of development assistance. In particular, Martin and Mistry urge the case for restructuring governments' negotiating teams so as to make them more cost-effective; the importance of greater continuity among IFI staff handling country negotiations; and the need for improving the work undertaken preparatory to Consultative Groups and other negotiating forums. They also make numerous suggestions for improving the reliability and objectivity of "financing gap" calculations in negotiations with the Fund and Bank.

The broader suggestions above are therefore best read in conjunction with these other recommendations.

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[43] Eligibility for SPA treatment is determined by three criteria: poverty, defined as those countries which receive credits from the World Bank group on IDA-only terms; debt distress; and commitment to IFI-supported adjustment programmes of policy reform (World Bank, 1990, p. 24). See Martin (1991, pp. 315-316), for a discussion of this subject.

[44] See also UNITAR (1993, chap. C, by Nihal Kappagoda), for a useful brief survey of the administrative and other domestic requirements for effective debt management.

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ESAF RENEWAL: PROJECT DECISION OR STRUCTURAL ENTRY POINT?

Reginald Herbold Green

Executive Summary

1. It is desirable to consider ESAF renewal within the context of the overall role of IMF involvement in structural adjustment in small, poor countries - the actual ESAF drawers.

2. Whether the IMF is or should be a development institution is partly a semantic issue. Whether it should provide a neo-IDA import support facility is quite a different question. Providing first-line liquidity to preserve policy continuity and an enabling climate for development is just as much a developmental role as is long-term soft lending. Arguably it is also one to which the IMF is better suited and one that no institution currently plays in respect to ESAF users.

3. Because policy continuity, resource adequacy and increased enterprise fixed capital formation are the three main obstacles to more payoff from structural adjustment for small, poor economies, the IMF's present gatekeeper/surveillance team role (and especially fine tuning of short-term macro-monetary targets) appears inappropriate for these countries. An IMF role centred on providing first-line liquidity access and write-down/buy-back arrangements on external debt might be more productive for all concerned.

4. In support of those functions, a neo-ESAF of SDR 1,500-2,000 million a year appears appropriate. Some "grandfather clause" type provision would be needed for current and potential "shadow" ESAF countries whose drawings may be of the order of $5,000 million altogether.

I. Introduction: what are the agendas for consideration?

Structural adjustment as such is not now at issue. Whatever its limitations and successes - and recent World Bank studies suggest that both are prominent and vary in balance among programmes - structural adjustment as a macro/sectoral framework for organizing and imposing conditions on international resource transfers to low income, low performance countries has become dominant since 1980 and will remain so at least for the remainder of the decade.

The nature and modalities of structural adjustment are, however, very much at issue. Its initial quasi-conflation with orthodox stabilization has to a substantial extent been ended. Issues of transformation, poverty reduction, modalities, contextuality, "national ownership", external debt writedown (rather than full repayment) and time perspective have been significantly to marginally synthesized into the originally rather skeletal macroeconomic model. That process continues.

The IMF's continuing role in the international financial system and in the interactions of national financial systems with it is also not in question. There is no consensus on what is desirable or possible, but few would advocate its abolition or the reduction of its role purely to data collection and analysis, even in respect to small, low income countries.

The ways in which the IMF should interact with structural adjustment are in question. Neither on design and negotiation, financing nor monitoring roles is there even a semblance of consensus. The disagreement is not merely over details of policy or style of relationships with governments of structurally adjusting economies. It includes questioning whether structural adjustment should be taken out of the short-term, financial magnitude management arena, which is the IMF's basic place of business (and expertise), and whether, therefore, the IMF should cease to play any significant role in its financing or in its design and monitoring.

The immediate question is whether the Enhanced Structural Adjustment Facility (ESAF) should be extended. The subsidiary questions on that basis turn on terms, uses, and, especially, size. Looking at the question that narrowly assumes the issue being addressed is primarily that of mobilizing adequate funds for structural adjustment, either no structural adjustment of the role of the International Financial Institutions (IFIs) and of the balance among long-term restructuring, medium-term reviving and rehabilitating and short-term contingency buffering finance is needed, or these issues can best be addressed independently of ESAF.

ESAF is a high conditionality facility, which opened for business in mid-1990 providing 0.5 per cent interest, and drawings for up to 10 years (half grace period), for low income countries with IFI-approved structural adjustment programmes. Approvals in force at 30 November 1992 were SDR 2,037 million of which SDR 1,252 million had been drawn. In practice, ESAF plays two roles - *de facto* refinancing of maturing standard IMF drawings and augmenting of IDA and bilateral import support credits. The shortfalls relate largely to time lags in negotiating high conditionality facilities and to hiatuses in disbursement resulting from the use of tight, short-term macro-monetary targets as a ground for suspension leading to time-consuming renegotiation.

The assumption that no restructuring of IFI involvement or of flexibility of finance is needed leads - unless one denies that structural adjustment is often constrained by inadequate funding - to the conclusion that ESAF should be renewed, should continue to be used basically for general import support and should be enlarged. To date, the view that there is a need for major restructuring of IFI involvement and of the structure/flexibility of the resources available (independently of total volume) has tended to lead to the conclusion that ESAF should be terminated, with existing SAF/ESAF drawings by structurally adjusting countries 'frozen' (e.g. converted to IDA terms, rolled over, perhaps administered by IDA). This would be part of a major structural reduction of the IMF's role in structural adjustment, at least in the low-income, medium to micro-size economies which in practice utilize SAF/ESAF.

Is this an appropriate issue-posing framework? It is rather like the early opposition to structural adjustment on the grounds that what was needed was more finance on the same lines as before and that macro and sectoral policy restructuring was inappropriate as a core element in international crisis management packages. Therefore, it is prudent to step back to the macro frame of structural adjustment financing and IFI involvement to see whether either needs to be altered structurally and, if so, how, before addressing ESAF and, implicitly, the role of the IMF in the design, monitoring and financing of structural adjustment.

If the overall question is taken to be structural, a series of sub-questions arise:

(1) What role - if any - does/should the IMF play in respect to development finance?

(2) How adequate are present resource transfers in support of structural adjustment programmes?

(3) How is short-term contingency finance to be built into structural adjustment financing packages?

(4) Why is structural adjustment - especially, but not only, in sub-Saharan Africa - frequently associated with low (and even falling) levels of gross fixed capital formation?

(5) What roles should the IMF play in structural adjustment:

    (a) design and negotiation

    (b) monitoring

    (c) financing?

(6) In the light of the answers to the previous questions, is ESAF an appropriate continuing modality?

(7) If so, for what uses, and on what terms should resources be channelled via ESAF, and what order of magnitude should they have?

(8) Even if ESAF is an inappropriate (or too narrow) modality, is there a structural adjustment financing role for the IMF? If so, how could it be more appropriately structured?

This is a much more basic and analytical agenda than the simple "ESAF or not? If so, how much, how soft?" one. That may not make it better in a decision-taking sense even if it does do so conceptually. If there are few problems with structural adjustment that marginal additions to international funding will not overcome; if ESAF is additional funding in danger of being lost (rather than restructured or relocated) if not continued; and if any issues of the appropriateness of present IMF levels of and approaches to structural adjustment are basically independent of ESAF, then time spent on the longer, deeper agenda is time wasted.

The overall, ongoing dialogue on structural adjustment - and the resulting structural adjustment of structural adjustment between the Bank's Accelerated Development Report (1981) and its Long Term Perspective Study (1989) complemented by its Poverty Reduction Handbook and Operational Directive (1992b) - suggests that it is not safe to make the assumptions necessary to justify focusing on ESAF renewal as a free standing issue complete in and of itself.

Therefore, this paper seeks to review the key issues and to set out the general balance of opinion on each of the eight questions addressed.

II. The IMF and development: what linkages?

The IMF has traditionally argued that it was not a development finance institution. By that it meant that long-term and - except under special, short-term circumstances - subsidized credits fall outside its terms of reference and that the design of real sectoral and micro-policy (as opposed to monetary macro-policy) lay outside its area of expertise.

The IMF has drawn back from that position since 1970 in two rather different ways, the second (typified by ESAF) being much more basic than the first (typified by the Oil Facility/Trust Fund).

(1) The Oil Facility/Trust Fund instituted in 1974 was designed to help countries face a sudden shock for a limited period of time and, because poorer members were seen as particularly limited in their capacity to adjust or to ride out such shocks, to make certain concessions to them in respect to interest rates and repayment periods. It was not a permanent mechanism, it had finite repayment periods in both theory and practice and did not involve the IMF in detailed micro and sectoral policy vetting - indeed it was in practice quite low conditionality.

(2) Subsequent to 1980, the IMF moved into detailed policy prescription and result vetting - albeit still largely at the macro-monetary level - and became a gatekeeper for structural adjustment lending. Both in response to pressure to back such requirements with resources and because structural adjustment in low income countries turned out to be long term (10 years of continuous programmes already in the case of Ghana) instead of medium term (three or at most five years) as initially envisaged, the Fund entered into a process of providing longer-term credit provision, *de facto* roll-overs, and concessions on interest rates leading to ESAF. Unlike the Oil Facility, the credits were open sided (as to justification) and *de facto* open ended (with no clear cut-off date or point even for particular countries) as well as being high conditionality involving very detailed policy prescribing and result vetting.

In the process, the IMF has ceased to play its traditional financing role for low income countries with structural adjustment programmes. It may or may not provide more drawings to some adjusting members; what it does not do for any country with a structural adjustment programme is to provide quick, ready-access first-line liquidity to cover the initial cash flow requirements of sudden, unprojected external shocks. As no other institution has taken over this role and none is likely to, the result is that an exogenous shock can least easily be buffered by a low income, structurally adjusting country even though these countries are particularly likely to sustain such shocks and particularly vulnerable to them.

The IMF has not matched this reduction in access to short-term crisis management finance with any systematic waiver or easing of short-term performance criteria. It may on occasion waive them, but it is not externally clear under what conditions, and - to a drawer at least - the whole process appears opaque, subjective and on a grace-and-favour basis.

Clearly, if being a development finance institution is defined as providing long-term finance, then the IMF has become more involved in development. Similarly, if setting overall and, to a degree, detailed sub-macro policy and performance requirements is seen as integral to development finance then the IMF is now more involved in that too. If, however, the IMF's role is perceived as giving broad guidance on short- (or long-) term macro-monetary enabling climates for stable development and providing the financial means to maintain stability of policy and praxis in the face of short-term liquidity crises (especially those flowing from exogenous events or unanticipated side effects of Fund/Bank-backed adjustment policies), then the Fund's role in development today is less effective than it was in the mid-1970s. It has come to overlap IDA in providing finance and the World Bank in providing detailed macro to micro, monetary and real advice backed by provision/withholding of finance. In the process no institution has been left to play its earlier role of stabilizing through provision of first-line liquidity.

That reopens the question of whether the IMF is a development institution from a somewhat different perspective. Clearly, access to first-line liquidity is not a sufficient condition for stable development. However, it is a conducive and perhaps a necessary one. Similarly, short-term credits, relatively limited in volume, are clearly inadequate either for rehabilitating debilitated capital stock bases or for providing the interim import capacity to raise utilization ratios in the cases of severe initial structural imbalance. But this does not necessarily mean they are unimportant - preserving stability and predictability is arguably even more important in a small, poor economy undertaking structural adjustment than it usually is. Because annual macro-budgeting in a Consultative Group or public finance context rarely includes contingency margins and is usually based on relatively optimistic assumptions, external shocks are particularly likely to require access to first-line liquidity. In the case of low income, structurally adjusting countries, virtually by definition neither external reserves nor international commercial banks are likely sources for such liquidity. Therefore, it is at least arguable that the IMF's primary duty as a development finance institution lies precisely in providing access to first-line liquidity not in quasi-replication of IDA's import support credits.

The IMF (including its longest serving official, Executive Director and intellectual leader - J. J. Polak) is clearly uneasy at the results of its post-1980 adjustment in respect to interaction with low income, structurally adjusting countries. It is far from convinced that trying to replicate the World Bank's real micro and sectoral expertise or shadowing IDA is an optimal path for the Fund. On the other hand, at least to date, no coherent proposals for any other strategic relationship to structural adjustment has emerged from Fund thinking. Above all it has not seriously questioned either its own role as a gatekeeper to structural adjustment programmes or the suitability of short-term, macro-monetary performance criteria for monitoring them.

III. The road to ESAF: model or muddle?

ESAF does not appear to have been the product of any medium-term Fund strategy as to how it should relate to the financing requirements of structural adjustment in small, poor countries. Rather it emerged from unanticipated pressures on structurally adjusting economies and on the Fund in the first half of the 1980s - particularly in sub-Saharan Africa (SSA) and paradigmatically in Ghana.

The main elements in the constellation of pressures were:

(1) the realization that, even if other structural imbalances were successfully addressed, closing export earnings/import requirements gaps would in many cases take at least a decade, partly because both primary commodity global trade volume growth and price trends (together dominating income terms of trade/earned import capacity for small, low income structurally adjusting economies) showed no signs of recovery to the conditions prevailing in the 1960s or second half of the 1970s, but tended to drift or lurch downward with very limited periods of partial recovery;

(2) acceptance that very large (relative to exports) IMF drawings based on traditional periods and interest rates were an inappropriate form of medium- to long-term adjustment finance. After all, IMF Agreements regularly included bans on any similar magnitude of borrowings on such terms from any other source;

(3) the recurrent need to use IMF finance to fill external resource mobilization gaps between what the Bank-Fund-country felt were the lowest flows consistent with sustained adjustment and what bilaterals would and the Bank could pledge. As "gatekeeper" the Fund felt an obligation to facilitate effectiveness of entry once it had issued a "gate pass";

(4) the realization that repayment of Stand-by or even Extended Arrangement drawings while a structural external account gap persisted would shatter programmes (very

particularly Ghana's) that both the Fund and the Bank viewed as well designed, seriously implemented and performing well on most criteria;

(5) a Fund disinclination to institute any generalizable pattern of back-to-back repurchase and redrawing (which would not in any case by itself have addressed the interest rate problem).

SAF and ESAF have responded to these pressures by virtue of the following:

- because the credits are long term (up to 10 years with about half grace period) and highly concessional, they do reduce both the immediate burden of interest charges and the medium-term burden of repayment;
- averting the twin risks that successful structural adjustment programmes will be shattered by the need to repay the IMF and/or that the IMF's "non-performing loan book" in Africa will balloon through the sudden addition of countries the IMF had - up to the day of default - been praising for virtuous conduct;
- by being freely usable - *de facto* general import, or priority debt service, support credits - SAF/ESAF drawings have allowed the IMF to channel funds to operational imports in order to reactivate under-utilized capacity (the quick payoff front of structural adjustment) and to avoid the need to work out detailed sectoral and project packages.

Another side of SAF/ESAF drawings at least as they relate to sub-Saharan Africa, has attracted less attention. The Fund appears to be engaged in a systematic two-track withdrawal of standard liquidity provision from the sub-continent, partly offset by SAF/ESAF drawings:

- new stand-by and extended arrangements are few and far between so that net repayments on such facilities began in 1984 and, since 1986 (the effective inauguration of the SAF/ESAF process), have been fluctuating around $1,000 million a year;
- at most half of this withdrawal of normal Fund resources has been refinanced by *de facto* conversions to ESAF.

Whether by intention or not, this strategy at least implicitly asserts that there is no place for traditional quick access first-line liquidity provision (contingency finance) in sub-Saharan Africa (SSA).

While, in principle (table 2), ESAF eligibility extends to virtually all low income countries (more liberally defined than by IDA), including China, India and Pakistan, the actual pattern of use (table 1) is somewhat narrower. The common characteristics are economic smallness, low income (in the IDA sense), a well established structural adjustment programme presence, and little prospect of overcoming the external account structural deficit by 2000. These characteristics pertain to many SSA economies and to lesser numbers of small Latin American/Caribbean and South Asian economies plus Bangladesh.

ESAF is not insignificant in size. As of late 1992, SAF/ESAF arrangements in force totalled SDR 2,037 million of which SDR 1,252 million had been drawn (table 1). However:

- this represents 10 per cent of authorizations and 13 per cent of drawings under programmes in force in late 1992;
- the amount is small relative either to IDA or to total external financial flows to small, low income structurally adjusting economies;
- much of it represents not new money but *de facto* conversion of old stand-by and extended facility drawings to ESAF to avert programme collapse and/or default on repurchase obligations.

With respect to continuity and predictability of finance, ESAF - like other IMF drawings - has had a negative impact, especially when an exogenous shock or the side effect of a SAP policy had a significant impact on outturn. More generally, ESAF causes discontinuous flows with unpredictable gaps since one agreement rarely flows smoothly into the next. For example, the SAFs for Chad, Guinea-Bissau and the United Republic of Tanzania expired in 1990. In no case was a smooth phase-in of a consecutive ESAF achieved. Indeed, as of late 1992 only the United Republic of Tanzania had negotiated an ESAF (arranged at the end of July 1991). This results in large part because short-term performance criteria have a far greater immediate impact on flows from the Fund than from the Bank or bilaterals. In the latter cases there is more time to agree on waiver, restructuring or modification of criteria which, in any event, tend to be relatively more flexible as to levels and dates of attainment if best efforts have been made and poor performance appears to be substantially related to events beyond the recipient's control and/or reasonable expectations at the time of the agreement.

Table 1

STAND-BY, EXTENDED, STRUCTURAL ADJUSTMENT FACILITY (SAF) AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY (ESAF) ARRANGEMENTS AS OF 30 NOVEMBER 1992

(Million SDRs)

Member	Date of arrangements	Expiration date	Amount agreed	Undrawn balance
Stand-by arrangements			**5,833.02**	**3,782.08**
Albania	26 August 1992	25 August 1993	20.00	13.75
Barbados	7 February 1992	31 May 1993	23.89	9.22
Brazil	29 January 1992	31 August 1993	1,500.00	1,372.50
Bulgaria	17 April 1992	16 April 1993	155.00	62.00
Czechoslovakia	3 April 1992	2 April 1993	236.00	200.00
Dominican Republic	28 August 1991	27 March 1993	39.24	39.24
Ecuador	11 December 1991	10 December 1992	75.00	56.44
Egypt	17 May 1991	1 March 1993	278.00	130.80
El Salvador	6 January 1992	5 March 1993	41.50	41.50
Estonia	16 September 1992	15 September 1993	27.90	20.15
Gabon	30 September 1991	29 March 1993	28.00	24.00
India	31 October 1991	30 June 1993	1,656.00	924.00
Jordan	26 February 1992	25 August 1993	44.40	22.20
Latvia	14 September 1992	13 September 1993	54.90	39.65
Lithuania	21 October 1992	20 September 1993	56.93	39.68
Mongolia	4 October 1991	31 December 1992	22.50	8.75
Morocco	31 January 1992	31 March 1993	91.98	73.58
Nicaragua	18 September 1991	17 March 1993	40.86	23.83
Panama	24 February 1992	23 December 1993	93.68	58.83
Philippines	20 February 1991	31 March 1993	264.20	56.60
Romania	29 May 1992	28 March 1993	314.04	52.34
Russian Federation	5 August 1992	4 January 1993	719.00	479.00
Uruguay	1 July 1992	30 June 1993	50.00	34.03
Extended arrangements			**12,188.55**	**5,962.35**
Argentina	31 March 1992	30 March 1995	2,149.25	1,857.09
Hungary	20 February 1991	19 February 1994	1,114.00	556.77
Mexico	26 May 1989	25 May 1993	3,729.60	466.20
Poland	18 April 1991	17 April 1994	1,224.00	1,147.50
Venezuela	23 June 1989	22 March 1993	3,857.10	1,851.50
Zimbabwe	11 September 1992	10 September 1995	114.60	83.30
SAF arrangements			**105.35**	**75.25**
Burkina Faso	13 March 1991	12 March 1994	22.12	15.80
Comoros	21 June 1991	20 June 1994	3.15	2.25
Ethiopia	28 October 1992	27 October 1995	49.42	35.30
Rwanda	24 April 1991	23 April 1994	30.66	21.90
ESAF arrangements			**2,037.30**	**785.03**
Bangladesh	10 August 1990	13 September 1993	345.00	28.75
Bolivia	27 July 1988	15 September 1993	163.26	13.61
Burundi	13 November 1991	12 November 1994	42.70	29.89
Guinea	6 November 1991	5 November 1994	57.90	40.53
Guyana	13 July 1990	12 July 1993	81.52	17.71
Honduras	24 July 1992	23 July 1995	40.68	33.90
Kenya	15 May 1989	31 March 1993	261.40	45.23
Lesotho	22 May 1991	21 May 1994	18.12	10.57
Malawi	15 July 1988	31 May 1993	66.96	5.58
Mali	28 August 1992	27 August 1995	60.96	50.80
Mozambique	1 June 1990	30 September 1993	100.65	30.50
Nepal	5 October 1992	4 October 1995	33.57	27.98
Sri Lanka	13 September 1991	12 September 1994	336.00	168.00
Tanzania, United Rep. of	29 July 1991	28 July 1994	181.90	128.40
Togo	31 May 1989	19 May 1993	46.08	7.68
Zimbabwe	11 September 1992	10 September 1995	200.60	145.90
Total			**20,164.22**	**10,604.71**

Source: IMF Treasurer's Department.

Note: Figures may not add up to totals because of rounding.

Table 2

IMF MEMBERS ELIGIBLE FOR ASSISTANCE UNDER THE ESAF

Afghanistan
Albania
Angola
Bangladesh
Benin
Bhutan
Bolivia
Burkina Faso
Burma
Burundi
Cambodia
Cape Verde
Central African Republic
Chad
China
Comoros
Côte d'Ivoire
Djibouti
Dominica
Dominican Republic
Egypt
Equatorial Guinea
Ethiopia
Gambia, The
Ghana
Grenada
Guinea
Guinea-Bissau
Guyana
Haiti
Honduras
India
Kenya
Kiribati
Lao P.D.R.
Lesotho
Liberia
Madagascar
Malawi
Maldives
Mali
Mauritania
Mongolia
Mozambique
Nepal
Nicaragua
Niger
Nigeria
Pakistan
Philippines
Rwanda
St. Kitts and Nevis
St. Lucia
St. Vincent
Sao Tome and Principe
Senegal
Sierra Leone
Solomon Islands
Somalia
Sri Lanka
Sudan
Tanzania, United Republic of
Togo
Tonga
Uganda
Vanuatu
Viet Nam
Western Samoa
Yemen
Zaire
Zambia
Zimbabwe

IV. Adequacy of finance: how constraining?

The World Bank's analysis of SAPs (World Bank, 1992a and Elbadawi, 1992) increasingly demonstrates two factors:

- higher levels of net external resource transfers improve performance - particularly in SSA;
- policy changes, resource transfer levels and improved performance are all correlated.

This means - quite apart from the evident difficulties of constructing counterfactuals, setting up meaningful time periods for multi-country comparisons, and/or categorizing countries as seriously pursuing structural adjustment (some, e.g. Zimbabwe in 1984-1990, without Fund/Bank approved SAPs in place) or not (some, e.g. Zaire during most of the past decade, with nominally approved SAPs) - that relating improved performance exclusively to policy changes or to additional resource transfers is implausible. Further, it suggests that the improvement may be a joint product of policy change combined with additional resources to make for the stability of the new policy framework as well as to take advantage of "enabling climate" opportunities for increased production.

The impression - or presumption - flowing from the cross-country data would appear to be confirmed by particular country experience. Ghana, which has seen an increase in external resource transfers from under $10 per capita pre-SAP to over $50 per capita during a decade of successive structural adjustment programmes, has achieved a reasonable growth rate, significant recovery of basic (human and social) services and rehabilitation of infrastructure. Thus, despite its disastrous terms-of-trade experience (1990 GDP was $800 million, 12.8 per cent below what it would have been *ceteris paribus* at 1980 terms of trade - see table 3) and the very slow recovery of gross fixed investment (the net figure was negative, on reasonable current price depreciation estimates, until perhaps 1988), a stable climate of positive economic expectations has been achieved as well as a considerable rehabilitation of public and business perceptions of the Government.

Table 3

CHANGE IN TERMS OF TRADE AND DEVELOPMENT ASSISTANCE IN SUB-SAHARAN AFRICA, BY COUNTRY, 1980-1990

Country	*Terms of trade 1990*	*Annual terms of trade loss/(gain), 1990*		*Increase/(decrease) in annual ODA 1980-1990*
	(1980 = 100)	*($ millions)*	*Per cent of 1990 GDP*	*1989 constant dollars (millions)*
Low-income				
Burkina Faso	98	3	0.0	(31)
Central African Rep.	94	8	0.6	54
Ghana	48	800	12.8	207
Kenya	75	344	3.9	449
Madagascar	85	59	1.9	(17)
Malawi	98	8	0.3	224
Mali	109	(29)	(1.2)	34
Mauritania	93	35	9.5	(58)
Niger	69	195	7.7	86
Nigeria	57	10,313	29.1	142
Rwanda	51	108	5.0	33
Sierra Leone	71	56	6.2	(73)
Tanzania, United Rep. of	77	90	3.8	104
Togo	72	117	7.2	72
Uganda	55	124	4.1	415
Lower middle-income				
Cameroon	63	704	6.3	52
Congo	70	484	16.9	59
Côte d'Ivoire	62	1,594	16.1	305
Senegal	102	(15)	(0.3)	296
Upper middle-income				
Gabon	63	1,451	30.1	43

Source: G.K. Helleiner, "External resource flows, debt relief and economic development in sub-Saharan Africa", paper presented at UNICEF Seminar on Adjustment and Development in Sub-Saharan Africa, Florence November 1992.

Note: Terms of trade: derived from UNCTAD, 1989 and World Bank, 1992a. Terms of trade loss: 1990 export value (from World Bank, 1992a) multiplied by 100/terms of trade, 1990 (1980 = 100) (from previous column) minus 1990 export value. Increase in ODA: derived from OECD, 1991, p. 213. Export volume growth rate: World Bank, 1992a.

In Zambia, by contrast, all pre-1992 structural adjustment programmes were underfunded. Before 1990 all implied a positive current account balance. In a demonstrably import-starved economy suffering from massive terms-of-trade deterioration (probably over 25 per cent of GDP as of 1990), the result of successive failed programmes, enthusiastically begun but rapidly abandoned in the face of economic decline and social unrest, should have been quite predictable (indeed was predicted by some observers, not necessarily excluding World Bank practitioners). The lack of policy adequacy and especially continuity cannot be seen as separate from inadequate finance. The results included - at least until 1992 - a disabling climate of expectations and a continued erosion of government credibility as demonstrated by the 1991 election results.

Another way of looking at adequacy would be to contrast exogenous (especially terms-of-trade) losses with ODA gains in structurally adjusting countries. In a majority of SSA cases for which data are readily available (tables 3 and 4), the former exceeded the latter and even in those for which this was not the case the positive margin has been narrow (e.g. the United Republic of Tanzania had $90 million losses and $104 million gains for a net of $14 million or 0.6 per cent of GDP in 1990). Since a majority of these economies already faced severe problems and their performance in 1980 was relatively poor, the data (table 3)

Table 4

THE IMF, THE WORLD BANK AND EXTERNAL TRANSFERS TO AFRICA, SOUTH OF THE SAHARA, 1980-1989

($ millons)

	1980	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
IMF								
Gross disbursements [a]	1,217	1,618	952	738	735	678	1,033	865
Repayments and interest [b]	487	739	993	1.172	1,689	1,541	1.495	1,593
Net transfer	730	879	-41	-434	-954	-863	-462	-728
IDA								
Disbursements	424	637	778	881	1,400	1,681	1,697	1,700
Repayments and interest	21	44	56	79	94	111	128	126
Net transfer	403	593	722	802	1.306	1,570	1,569	1,574
World Bank								
Disbursements	400	708	832	647	898	998	581	835
Repayments and interest	328	438	527	616	865	1,073	1.306	1,226
Net transfer	72	270	305	31	33	-75	-725	-391
IMF/IDA/World Bank								
Total net transfers	1,205	1,742	986	399	385	632	382	455
Other net transfers (long-term debt):								
Multilateral [c]	707	664	442	487	650	709	672	607
Bilateral [c]	1,657	2,295	1,925	472	1,210	1.194	630	945
Private [d]	2,818	270	-1,667	-2,648	-1,132	-213	-434	-428
Total long-term debt and related net transfers	5,657	4,092	1,727	-856	2,067	3,185	1,712	2,307
Grants [e]	3,057	2.844	3,422	4.514	4,823	5.030	6,567	6,570
Direct foreign investment	20	882	494	1,059	460	1,167	687	2,301
Total net transfers	6,573	7,485	4,419	2,779	5,209	6,763	7,511	8,692

Source: G.K. Helleiner, "The IMF, the World Bank and Africa's adjustment and external debt problems: An unofficial view", *World Development*, vol. 20, No. 6, 1992 (June).

a Gross disbursements.
b Repayments and interest.
c Excluding grants.
d Publicly guaranteed and unguaranteed, excluding direct or foreign investment.
e Excluding technical assistance.

strongly suggest resource inadequacy. The data for other small, low income countries are not as readily available but several, e.g. Guyana, Honduras, Sri Lanka and Bangladesh, appear to have ODA gain/terms-of-trade loss balances ranging from minimally positive to highly negative.

For sub-Saharan Africa, the overall net resource transfer record (table 4) shows 15 per cent current price growth over 1980-1983 followed by a 65 per cent fall over 1983-1985 and growth over 1985-1989 (the rapid SAP expansion period) of 210 per cent, with 1989 about 16 per cent above 1980 in nominal terms or about 30 per cent lower in constant price per capita terms, even independently of adjustment for terms-of-trade losses.

Unless a negative correlation is posited between resource availability and sustained policy reform, which is quite against the weight of the evidence as analysed by the World Bank, the case for additional resource transfers in support of structural adjustment programmes is overwhelming even if reasonable persons may differ on how much more. The one area in which the World Bank's SSA studies were not structurally adjusted between 1981 and 1989 is on the need for additional net transfers. Except for the first (which called for doubling in real terms between 1980 and 1985), the projected requirements have tended to appear optimistic to analysts but daunting or impossible to resource providers/mobilizers suggesting a compromise (perhaps subliminal) between projections of programme requirements and of possible mobilization ceilings. Certainly that tension has entered into the preparation of a number of individual country Consultative Group submissions.

Within the total, categories and subcategories have evolved very differently. Bilateral ODA and non-IFI multilateral ODA rose 45 per cent with loans falling 35 per cent (largely early in the decade) and grants rising 115 per cent (mainly in its second half). The Bank Group's net transfers rose 150 per cent (peaking in 1987), with an IDA growth of 190 per cent (all achieved by 1987), more than offsetting a Bank proper swing from net transfers of $403 million (6 per cent of all net transfers) in 1980 to a net outflow of $391 million in 1989 (slightly under 5 per cent of that year's total, but representing a recovery from -$725 million and 9 per cent in 1988). This suggests a catalytic role by the Bank in structural adjustment launching, with bilateral grants taking up the slack as confidence in structural adjustment programmes rose and the Bank's ability either to increase IDA's total resources or to reallocate resources from the larger Asian low income countries to the smaller SSA low income countries became increasingly constrained.

The IMF's record is quite different. In 1980 net transfers were $730 million (11 per cent of the total). From 1984 on they have been negative, with an outflow of $728 million in 1989 (virtually a 9 per cent offset to the net transfer total) (table 4). If SAF/ESAF were excluded, the net repayment trend would be even more marked. After 1989 there was a decline in net outflows as ESAF expanded disbursements, payments on earlier facilities by States able to pay ran down and several cases of arrears remained insoluble. Had the IMF maintained its absolute net transfer level of 1980, in 1989 net transfers to SSA would have been one sixth higher ($10,160 million instead of the actual figure of $8,692 million). In the context of overall inadequacy of net transfers, the IMF's record does indeed provide grounds for concern.

V. First-line liquidity: the missing link

Small, low income economies are in almost all cases extremely susceptible to external shocks. They are also both economically, and frequently ecologically, rigid and brittle. Rapid adjustment through alteration of export and production patterns is therefore difficult to impossible. Radical reduction of import absorption (whether via prices or rationing) is likely to multiply negative production impact and to exacerbate fiscal imbalances.

The case for riding out short-term self-reversing shocks (e.g. drought) and of having a breathing space to phase-in adjustment to less temporary ones (e.g. terms-of-trade deterioration) is reasonably evident. The optimal way is doubtless to hold high levels of external reserves for contingency use. In the case of many of these economies the standard three-month rule of thumb is probably inadequate - six months might be more prudent. However, most structurally adjusting small, poor countries have very low external reserves (often one to two months' imports) as a result of historically low exports relative to import demand and up to three decades of economic malaise.

Therefore these economies need access to first-line liquidity to bridge the gap between the shock and either its reversal or more permanent adjustment. For example, in the case of drought, external assistance can usually be secured but with a time-lag; consequently interim imports must be financed out of nationally provided foreign exchange as, for example, in Zimbabwe and Zambia in 1992. There are three basic sources of such liquidity:

- commercial banks;
- the IMF;
- external assistance.

Understandably, very few small, poor, structurally adjusting countries have access to new commercial bank credits beyond revolving trade credits often backed by pledging future exports. An external shock threatening economic performance is likely to call existing facilities into question, not be an occasion for negotiating additional ones.

The IMF was created primarily to set up a financial enabling climate for international trade. Historically it was the major source of first-line liquidity, although since 1970 it is arguable that commercial banks have ousted it from that role for most middle- and large-sized economies. But it does not offer access to first-line liquidity to any country with a high conditionality drawing facility. All drawings from such facilities are, in fact, included in external financial projections, which are frequently over-optimistic and certainly provide no margin for substantial negative exogenous shocks.

At first glance the IMF's Compensatory and Contingency Facilities might seem to be first-line-liquidity oriented. Indeed in the mid-1970s the Compensatory Facility arguably did play that role. However, today both are high conditionality facilities utilized in association with SAPS. Therefore they cannot be rapid access facilities.

The symmetry principle providing for accelerated repayment after favourable shocks has bedevilled Contingency Facility dialogue. While the concept makes sense in practice, the application represents an inefficient attempt at fine tuning. Drawings are unlikely to have fully offset the negative shock; the magnitude of a positive shock is a matter of judgement; early repayments would probably be trivial to the IMF. The combination of high conditionality/negotiation lags and symmetry make the Compensatory and Contingency Facilities virtually useless as first-line liquidity sources. In principle they could be restructured as low conditionality, speedy access facilities. In practice, restructuring ESAF is likely to prove easier and quicker (or less problematic).

In principle, the IMF is ready to renegotiate drawing schedules and indeed created a small contingency facility in 1988. This has never been used and the time normally required for renegotiation rules it out as a source of first-line liquidity. Indeed, since exogenous shocks do not result in the automatic loosening - let alone waiver - of performance criteria, one result of an exogenous shock is all too likely to be the suspension of access to an existing agreement with the IMF, rather than the negotiation of a new or enhanced one.

External assistance negotiated after a shock is unsatisfactory as a source of first-line liquidity because of time-lags. Even in the case of drought crises - in respect to which additional ODA is more often than not forthcoming - the lag from clear identification of the crisis to the significant arrival of ODA-financed imports is rarely under six months, which entails either heavy use of domestic external flows or reserves or a build-up of forced migration and near famine conditions. In the case of economic shocks - e.g. terms of trade - the lag is even greater.

In principle, contingency reserves (and conditions to trigger their use) could be built into Policy Framework Papers and Consultancy Group proposal and pledging matrices. In practice this does not happen. The proposals to the Consultative Groups (or their poor relations, UNDP Round-tables) are normally a compromise between what the country feels is the minimum foreign exchange and finance needed and what the international sponsoring agency (which often agrees on the need level) thinks is the highest request that will not drive prospective donors away. Thus, no contingency margin - let alone 'facility' - is built into the proposals. Further, virtually all Consultative Group/Round-table pledges fall below proposed levels and virtually all deliveries are either below pledged levels, significantly lagged (which, on a cash-flow basis, comes to the same thing), or both.

Thus, the group of countries that arguably have the greatest need for access to first-line liquidity in fact have the least. This is a major weakness in the present structuring of international support for structural adjustment.

This statement is not intended to imply that short-term liquidity credit is a satisfactory source of finance to resolve structural problems. What it does is to make the very different assertion that the presence of structural problems does not mean the absence of stochastic shocks or reduce the need for immediate access to resources to cope with shocks in the short run. Arguably such credit could be on normal terms (perhaps with an explicit interest rate subsidy) if subsequent Consultative Group/Round-table meetings specifically dealt not only with issues relating to longer-term adjustment but also with the refinancing of the initial short-term borrowing.

VI. Fixed capital formation: a problem for sustainable adjustment

Structurally adjusting economies have been marked by low average levels of gross fixed capital formation (GFCF) and often with negative net ones if depreciation in the National Accounts is calculated on replacement cost. The most typical pattern is an initial fall followed by a lagged, sluggish recovery (Elbadawi, 1992).

This is a statement of empirical reality which is documented in World Bank reviews of structural adjustment performance. It does not assert that structural adjustment is the cause of unsustainably low levels of GFCF, but it does indicate that up to now structural adjustment programmes and strategies have failed to deal with that problem.

The initial decline is understandable and may be desirable. A typical economy entering into structural adjustment has very severe imbalances including low capacity utilization and deferred maintenance. Initially radical reduction of macro-policy distortions, backed by a shift of resources (and import capacity) to higher capacity utilization, catch-up maintenance (which rarely figures fully as capital formation in national aggregates), and rehabilitation of basic public services makes good sense (cf. Helleiner, 1992a). It can fairly rapidly generate output growth and an improved government fiscal position. So long as key bottlenecks and rebuilding are addressed on the fixed investment side, that approach can be strategically sound for several years (as demonstrated in Zimbabwe's nationally designed structural adjustment programme over 1984-1990 which generated about 4.5 per cent annual real GDP growth even though GFCF was 10 per cent to 15 per cent of GDP and adjusted net fixed capital formation negligible to 5 per cent).

However, such a shift cannot be sustainable beyond, say, three to six years:

(1) Raising output out of stagnant capacity will shortly run into capacity constraints (as in Zimbabwe by 1990);

(2) Transformation is likely to require different, and therefore new, fixed investment, not least in export diversification;

(3) Infrastructural capacity, after the rehabilitation phase, is likely to pose both qualitative and quantitative constraints fairly quickly.

This is not an area of major disagreement among the IFIs, the bilaterals and the small, poor adjusting economies. While there are some divergences on issues of timing, sequencing and volume, what is remarkable is the shift of consensus from a fixed-investment-first approach (all else including capacity utilization being cut) to the correction of gross distortions paralleled by restoration of production of goods and basic services followed by GFCF restoration strategy. This is a sub-strategy of structural adjustment for small, poor countries. Its distinctive features, *inter alia*, include implicit acceptance of plugging fiscal gaps with ODA (especially import support finance with the government selling import capacity to the enterprise sector so that it can restore capacity while the government reduces or eliminates domestic bank borrowing), and rather more open acceptance that exceptional import capacity transfers may be needed for up to a decade before normal investment plus export growth restore a less-ODA-fuelled and sustained recovery and adjustment process.

This sub-strategy has several consequences:

(1) Pressure on the domestic banking system is reduced; the government virtually ceases to be a borrower and the entire domestic credit formation expansion ceiling (which remains a trigger clause), such as it is, is available to the enterprise sector;

(2) ODA becomes a larger element on the supply side of general import capacity so that "sustainable exchange rate" projections, to be meaningful must incorporate ODA (and in particular import support ODA), as well as other major sources of import capacity;

(3) Government investment restoration usually leads enterprise sector investment recovery, and the latter is initially concentrated on working capital to finance restored capacity utilization (especially stocks of raw materials, goods in process, final products, spare parts and credit to wholesalers and retailers);

(4) Government economic activity thus is likely to pull in enterprise GFCF in four ways:

    - overall demand recovery,
    - restoration of infrastructure (especially transport, communications and energy),
    - removal of gross price distortions (e.g. exchange rates), of shortages (e.g. of imported inputs and of bank credit), and of regulations (e.g. of prices and of external transactions), which literally prevent enterprise activity or make it more costly and less efficient,
    - creation of a relatively stable climate of enabling economic policy and practice, raising faith in the future viability of present and future fixed capital investments.

The IMF has accepted this model in SSA - though less so in some other ESAF-eligible economies that might have benefited from it (notably the Philippines). However, the word is "accepted" - this structural adjustment of structural adjustment is basically the product of interaction and discourse among recipient countries (recipients of ODA and of adjustment costs as well as of gains), non-financial international institutions (notably UNICEF) and the World Bank. That process and the characteristics of the new model raise questions about the IMF's continued role as "gatekeeper" and as surveillance team for short-term macro-monetary performance criteria with non-feasance in respect to the latter nominally (though increasingly less so in practice except for ESAF and other IMF flows), the result being to slam the gate shut again.

However, the main problem at present is not with the implicit model or with IMF cooperation/acquiescence in it. Rather it is the failure - or at any rate the pace and level - of enterprise sector fixed investment recovery. Given the financing sources of the government investment recovery, the basic problem is usually unlikely to be crowding out (e.g. in Ghana, the United Republic of Tanzania and even Mozambique, government domestic banking system borrowing has become negative and - including grant ODA - the recurrent budgets are in surplus). Nor would it appear to be that small, low income structurally adjusting economies have on average made fewer changes or shown less commitment. The World Bank's conclusion in its 1992 evaluation with respect to SSA adjusting countries, which are all in this category and comprise a majority of its members, is "They had undertaken more, not less, adjustment ... The differences in average economic outcomes seem to result from differences in the [starting baseline] level of development" (World Bank, 1992a, p. 14).

That conclusion implies that if:

(1) import capacity growth (very highly correlated with renewed growth in adjusting economies) is kept up,

(2) gross policy and price distortions are avoided,

(3) the economic climate remains, stable and enabling for several years and is expected to continue to be so, and

(4) there are mechanisms that allow buffering of exogenous shocks,

then the spirits of entrepreneurs (usually led by domestic ones) will rise and with them investment. But the process will take longer than has been expected - as have all other positive results in low income, small, structurally adjusting economies. Further, both profitability and prudence suggest that initial enterprise investment recovery will be biased towards working capital and that new fixed investment will initially focus heavily on restoration/expansion of pre-existing export capacity now rendered profitable and less uncertain by sustained policy change (e.g. timber processing and gold mining in Ghana).

However, for that to happen:

(1) either enhanced ODA inflows or reduced debt service outflows or both will be needed over the foreseeable future;

(2) contingency finance (first-line liquidity plus longer-term adjustment to new shocks) is very important to preserve the climate of continuity and gradual improvement needed to draw in enterprise investment (*vide* the collapse of investors' spirits in Zimbabwe in 1991-1992 when a self-validating exchange rate collapse domestic inflation acceleration spiral emerged from liberalization under phase two structural adjustment and was locked in place when drought required the diversion of major amounts of domestic import capacity to grain because of the absence of effective access to first-line liquidity.)

ESAF is not directly relevant to this scenario. Clearly it is neither channelled directly to the enterprise sector nor, to the extent that the enterprise sector buys the import capacity it provides, is it used primarily to cover the import requirements of enterprise fixed investment. However, like other import finance, it is a contributor to the durable recovery of import capacity, which is the first prerequisite for sustaining policy and demand improvement long enough to restore entrepreneurs' spirits and therefore their investment (cf. Helleiner, 1992a, Serven and Solimano, 1990).

VII. Structural adjustment of Fund roles?

The IMF's role in structural adjustment has never been primarily one of providing finance. For the larger economies it does not have the resources; for the smaller poorer ones it (correctly) perceives its standard facilities as inappropriate; it is ill at ease with the idea of substantial long-term lending and has never sought to finance ESAF at levels high enough to do more than give a modest boost to import support finance and a major boost to IMF attempts to disentangle from late 1970s and early 1980s standard facility overlending in SSA.

The IMF's role has been and remains primarily that of "gatekeeper" and compliance officer - roles it shares with the World Bank. Without an IMF agreement (whether for drawings, at zero targeted drawings or shadow), no internationally approved structural adjustment programme can exist and the World Bank-led Consultative Group financial mobilization process cannot begin. Once there is an agreement, progress towards quantified, dated, short-term macro-monetary targets is checked regularly and failure to meet the targets leads to suspension of IMF drawings and renegotiation. The risk to other external funds (including the World Bank's) is much less, especially if unforeseeable events have influenced results and/or movement is in the desired direction.

Therefore, before considering what to do with regard to ESAF it is appropriate to consider what the future role of the IMF should be in structural adjustment in respect to small, poor countries. Realistically "none" is not a viable answer and, indeed, is not an appropriate one in respect to first-line liquidity.

The IMF's short-term macro-monetary target approach is unsatisfactory as a frame for medium-term, focused structural adjustment focused on real-supply enhancement. At least in small, poor economies, rigidities are severe enough and external shocks sufficiently frequent for short-term (often quarterly) targets - quite apart from seasonality and other projection problems - to be unsuitable. Gatekeeping/surveillance together with the World Bank reduces some of these problems but does not fully overcome them and introduces very real tensions between the two IFIs (even if these are usually diplomatically veiled).

For small, poor countries (basically the ESAF eligible list minus China, India and probably Pakistan), the external side of programme design, negotiation and mobilization should be led by the World Bank. The IMF would be consulted, especially on exchange rates, monetary policy, financial institutions and related macro-monetary issues, but would not be a separate gatekeeper.

By the same token, performance targets would be medium-term ranges, not single numbers and - under predefined conditions - waived or rolled forward after exogenous shocks. The IMF's views and expertise (like those of the recipient country, UNDP, UNICEF and other bodies) would be taken into account by the World Bank in proposing or negotiating such targets to or with new or ongoing programme-adjusting countries, but there would be a single set of targets and a single monitoring process. The latter should be designed to reduce its demands on poor, small economies' scarcest resource - able analysts and other senior economic design and management personnel.

However, in two areas the Fund should play a more active role than it does now:

(1) external debt write-down and provision of finance for Baker-plus type packages;

(2) restoration of access to first-line liquidity (possibly with provision for its refinancing in subsequent Consultative Group packages), including stand-by facilities to avert self-validating but economically unhelpful currency sink/inflation rise spirals.

These - especially the second - are areas of Fund expertise and traditional leadership in which the principles of specialization and division of labour suggest that its low profile during the 1980s in respect to small, poor countries has been unwise and damaging to the Fund's own stated purposes and their relevance to creating an enabling climate for policy and performance continuity conducive to development.

VIII. And what of ESAF?

ESAF as it is operated now is not relevant to the proposed structural adjustment of the IMF's roles. It is a marginal IDA and as such the resources used for it could better be merged with IDA or, better still, allocated to the Regional Development Funds of the Regional Development Banks whose ability to participate in structural adjustment by their borrower member States is significantly constrained by limited access to soft finance. From a continuity perspective IDA and the RDFs are higher quality sources - disbursements are not suddenly suspended on the basis of rigid, quarterly macro-monetary target performance tests.

Approval of neo-ESAF for three years on this basis would require SDR 4,500-6,000 million because gross disbursements would not be significantly reduced by repurchases over that period. How to finance that amount (if the principle is agreed) turns on what routes are most convenient or acceptable to the IMF and those members called on to make contributions. Options (jointly or severally) include:

- reallocation of resources nominally designated for *Compensatory/Contingency* Facility use;
- allocations out of IMF profits;
- gold sales with profits allocated to neo-ESAF;
- allocation of receipts from repurchases of standard IMF drawings by ESAF eligible countries;
- funding by industrial and other surplus IMF member States.

The case against winding up ESAF is threefold:

(1) If ESAF were not renewed there is no guarantee a comparable increase in RDF and/or IDA resources would be secured;

(2) ESAF, in practice, guarantees an adjusting country, which stays roughly on target and has high past IMF drawings, that repurchase obligations will not cause its programme to collapse because the Fund will *de facto* roll the old drawings over into softer, longer-term ESAF drawings;

(3) If the IMF is to do more in respect to debt write-downs and first-line liquidity provisions, there are appropriate uses for the ESAF resource flows even if they are not the same as the present ones.

IX. Towards a structurally transformed ESAF?

If ESAF is to be continued it should be focused on:

- providing rapid access first-line liquidity to small, poor structurally adjusting countries experiencing severe exogenous shocks or self-validating exchange rate collapse/domestic inflation acceleration spirals following liberalization;
- providing finance for commercial debt write-down/buy-back deals.

The present repayment period of approximately 10 years with five years grace is not necessarily appropriate (the 0.5 per cent interest rate is) as the former could in some cases be shorter, especially if refinance can be built into subsequent Consultative Group programmes and the latter might more appropriately have a 15- or 20-year maximum repayment period.

The appropriate size requires further study. For what it is worth, ESAF commitments over the first two years totalled about SDR 2,100 million and drawings SDR 1,200 million. However, the proposed purposes are rather different and the actual 1990-1992 flows were well below target. Given the substantial debt overhang, the keen desire for exit by lenders to poor, small economies and the numerous shocks (individually unpredictable but collectively quite foreseeable), renewal at an annual rate of SDR 1,500-2,000 million a year might be appropriate. That level assumes that, whether formally eligible or not, China, India and Pakistan would not use the facility. It also assumes Consultative Group ex-post refinance of the bulk of first-line liquidity drawings in respect to shocks not fully or rapidly reversed.

If this route is taken, no major problem need arise with regard to present ESAF drawing repayments so long as the recipient economies do recover and substantial Consultative Group finance remains available. However, several ESAF eligible countries with actual or potential "shadow" agreements (notably Zambia but potentially others, e.g. Nigeria, Sudan) would require special "grandfather clause" consideration. They drew to cover structural not cyclical deficits, cannot afford standard IMF interest rates and can only repurchase by borrowing from somewhere else. Two ways of handling this are worth exploring:

(1) Specific provision through Consultative Groups for repaying currently outstanding standard facility IMF drawings in the case of a predefined group of countries;

(2) An IMF conversion facility (to terms similar to the present ESAF), perhaps on a once-for-all basis for each eligible country. Total outstandings involved could be $5,000 million.

With respect to first-line liquidity the facility would be low conditionality, quick access, limited total access. Evidence of an unforeseen (and reasonably unforeseeable) shock, which threatened to cripple an otherwise satisfactory structural adjustment (or immediate post-structural-adjustment transformation) programme would be grounds for drawing, and the size would be determined by the external account implications of the shock (e.g. grain imports plus related vehicle and fuel imports in the case of drought) up to 50 per cent of quota in any one year with a total of 75 per cent. Interest would be 0.5 per cent. Repayment could either be over 10 years with three years' grace or over five years with two years' grace, if arrangements are made for Consultative Groups to provide grants or soft, long, credit funds to refinance. Following the initial shock, continuing (or non-reversed) losses (e.g. on beverage price declines) could be financed via the Consultative Groups (as has *de facto* been done in the case of Ghana). The basic neo-ESAF role would be bridging finance - the original core IMF function.

A special first-line liquidity requirement is to avert downward exchange rate spirals interacting with rising domestic inflation following liberalization. These, once begun, are self validating if the country has no foreign exchange to calm the market. A notable case is that of Zimbabwe in 1991-1992, when devaluation far exceeded any reasonable estimate of initial over-valuation and, largely as a result, inflation doubled, creating a highly negative climate for output, enterprise profits and business confidence. In small, poor economies the volume of expectational purchase finance is usually limited so that manageable levels of stand-by drawing arrangements should be adequate to avert or break such spirals.

While most small, poor structurally adjusting countries - almost all of which are moderately to catastrophically debt distressed (at least if full payment ever is assumed) - are predominantly official borrowers, several have by no means insignificant commercial borrowings (notably Nigeria, Côte d'Ivoire, Philippines, Angola, Sudan and Cameroon, which presumably will become ESAF eligible). For many the Baker-plus terms granted to Egypt, Poland, Costa Rica and Nicaragua would be adequate. For the most severely distressed (e.g. Mozambique, United Republic of Tanzania, Somalia, Sudan) a Bolivian style buy-back at under 20 per cent of face value would be needed.

The present Fund/Bank support for refinancings/buy-backs has been used to a limited extent partly because it has tended to be at standard Bank/Fund interest rates. Were interest reduced to 0.5 per cent, then a five-year grace period, and a 10- to 20-year total duration should be manageable. While much of the debt in question is serviced only partially and fitfully and in the extreme cases there is little real pressure today because the creditors know very little can be paid, clearing these arrears and overhangs would be valuable:

- to general investor attitude to the country;
- to ensuring that interest and dividends on new enterprise investment could, if earned, be transferred;
- for allowing renewed access to revolving trade credits and use of confirmed letters of acceptance, thereby reducing the amount of foreign exchange working capital tied up in trading and manufacturing stocks of imported goods;
- for possibly reducing the incidence of prices above the going rate paid for standard imports, (apparently, according to partial World Bank studies, up to 20-25 per cent overall for SSA) which probably relates in part to past payments defaults and present perceived payments risk even for cash on delivery shipments.

These uses of neo-ESAF would not directly address the gross fixed capital formation level rehabilitation problem. Indirectly, however, they would contribute to reducing it:

- access to first-line liquidity would help to maintain policy and performance stability and potential investor confidence in its continuation;
- the resolution of the past debt overhang would increase investor confidence that new investments (whether loan or equity) could be serviced in foreign exchange if domestic surpluses were earned.

ESAF should therefore be renewed but as part of a restructured IMF role in structural adjustment programmes for small poor countries.

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SUGGESTIONS FOR INTERNATIONAL COLLABORATION TO REDUCE DESTABILIZING EFFECTS OF INTERNATIONAL CAPITAL MOBILITY ON THE DEVELOPING COUNTRIES

David Felix[*]

Executive Summary

The negative consequences of the vastly increased international financial mobility of the past two decades have become a matter of increasing concern in the industrialized countries. They include:

1. Excessive hot money flows that intensify exchange rate volatility, disrupt commodity trade, and weaken the effectiveness of conventional monetary-fiscal stabilization policies.

2. Deregulatory competition that undermines national prudential controls over banks and other financial intermediaries and increases the incidence of global financial crises.

3. Augmented capital flight facilities for illicit tax evasion and money laundering.

Concurrently, the welfare gains from policy shifts to flexible exchange rates and the liberalizing of capital markets are proving to be disappointingly meagre. Financial globalization has not brought to the world economy improved allocative efficiency, faster or more stable economic growth, or improved income distribution.

Since developing countries are even more victimized by the adverse consequences of international financial mobility, they should be active participants in the ongoing collaborative efforts by the industrialized countries to reduce such negative aspects, while preserving international capital mobility. Yet this has not been the case; developing countries have been passive observers. They have not sought to shape the collaborative mechanisms to deal more effectively with their special vulnerability to capital flight, tax evasion and their weak governance over multinational bank subsidiaries within their domain. Nor have they been exploiting the openings that the collaborative mechanisms recently established by the industrial economies provide for reducing their special vulnerabilities.

Part III of this paper urges the G-24 to help to lead the developing countries out of such unproductive passivity. It details existing collaborative mechanisms, the openings they present, and ways in which they could better address these countries' needs. It also develops the argument that changing ideological currents may now be reinforcing the pragmatic case for developing-industrial country collaboration in containing the negative aspects of international financial mobility. This should enhance the receptivity for proposals along the lines suggested were they to be incorporated in the G-24's forthcoming communiqué.

Introduction

Currently the dark side of international financial mobility is evoking increasing concern in official circles of the industrialized capitalist world. As *The Economist* recently observed:

> Increasingly, the case for a return to (explicitor implicit) restrictions on capital flows is likely to be put, and on both sides of the Atlantic. Recent turbulence in the currency markets has not been confined to the ERM ... Nicholas Brady, America's treasury secretary, has already said that the G7 countries "need to look at global capital flows", and a working group of officials has been created for the purpose. Might controls

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be part of the remedy for flows of hot money?[1]

The disruptive impact of speculative flows on the industrialized economics and on the ability of their governments to dampen exchange and interest rate volatility, while stabilizing the price level and maintaining high levels of output and employment, is behind the reviving interest in re-establishing some control over the flows. But restraining hot money flows merely adds to a litany of concerns over undesirable consequences of international financial mobility that have already sparked inter-governmental actions. A succession of bank crises with international ramifications have since the mid-1970s made it imperative to strengthen the coordinated supervision of the international operations of commercial banks of the countries affiliated with the Bank for International Settlements (BIS). More recently, procedures for the exchange of information between monetary authorities of the BIS countries and offshore banking havens have been strengthened for the added purpose of tracing asset ownership networks related to illegal money laundering, the drug trade and tax evasion. These illegalities are now also motivating formal agreements for the exchange of tax information between national authorities pursuing tax fraud and evasion.

Thus far the developing countries have been bystanders or passive participants in all this. At the initiative of the major industrial countries, developing countries serving as international tax and banking havens, and others domiciling elements of the drug trade, are being pressured to collaborate in the bank information networks devised by BIS conventions, and to enter into bilateral agreements for the exchange of tax information. But they have not been actively involved in shaping the conventions or in using the control mechanisms to address their particular stabilization needs. Nor do they appear to have sought such formal participation.

The published policy papers of the IMF and World Bank tacitly encourage this passivity. The recent papers give due recognition to the problematics of volatile exchange rates and free capital mobility. They agree that the welfare gains for the industrialized countries had been seriously overestimated by proponents of flexible exchange rates and the liberalization of international capital movements, and that the actual gains to date - reduced transactions costs and accelerated speed of financial trading - may have been more than offset by losses from greater macroeconomic instability and diminished national policy autonomy. They cautiously approve some of the actions undertaken by industrialized countries to strengthen controls over exchange markets and international banking activities. But as regards the developing countries, the IMF and World Bank policy papers continue to stress merely the benefits of liberating financial markets and lifting restrictions on foreign capital inflows and outflows. Overtly or inferentially, the policy advice to developing countries continues to be to keep opening up their economies financially and leave the regulating and policing of international financial flows to the industrialized countries.

This paper contends, however, that developing country economies are even more vulnerable to macroeconomic disruption from uncontrolled international capital flows than are the industrialized economies. The developing countries should therefore seek a more active role in shaping the multinational collaborative efforts and control instruments so as to deal more effectively with their greater vulnerability to financial and fiscal disruptions from hot money sorties, capital flight and tax evasion. Some specific proposals along these lines are suggested to the Ministers of the International Group of 24 on International Monetary Affairs (hereinafter the G-24) for inclusion in the communiqué they are formulating for the 1993 IMF-World Bank annual meeting. The intent of the proposals is to obtain collaboration from the advanced economies in reducing the above-mentioned negative effects of international capital mobility on the developing countries. Since they interface with parallel concerns of the advanced countries, it should be possible to get a serious hearing and perhaps even affirmative action on the proposals from the advanced countries. At the least, they might initiate an airing of the issues that could lead to future action.

This paper is organized as follows: Part I assesses the general case for constraining free capital mobility, while part II analyses the particular vulnerabilities of the developing economies. Part III surveys recent developments in international collaboration to strengthen the prudential supervision of international banking and to close channels for money laundering and tax evasion, and suggests ways for the developing countries to exploit these developments jointly in order to reduce their own vulnerabilities to hot money flows, capital flight and tax evasion. Finally, the appendix to the paper presents relevant statistical tables and a sample agreement on the bilateral exchange of tax information.

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[1] "The way we were", *The Economist* (London, 3 October 1992), p. 71. The ERM (Exchange Rate Mechanism) turbulence refers to the successive speculative runs in September 1992 against the currencies of Britain, Italy, Ireland and Spain, which drove all four countries to withdraw "temporarily" from the ERM. Through the ERM, the member countries of the European Community have sought to stablize their cross-exchange rates by coordinating their monetary policies and by joint emergency credits to protect the rate structure against speculative attacks. But substantial emergency assistance, mainly from Germany, proved inadequate to halt the runs, and the four countries were quickly forced to withdraw from the ERM and let their currencies depreciate. At the time of writing the French franc is the latest target of speculative attack. The inability of the ERM to stabilize the cross-rates in the face of such speculative onslaughts has cast a pall over Europe's drive toward economic union.

I. General problems with flexible exchange rates and free international capital mobility

In a provocative 1953 paper,[2] Milton Friedman sought to show that a flexible exchange rate regime with free capital movements would provide the following advantages over the regnant Bretton Woods fixed exchange rate regime:

(1) Allowed to adjust freely, exchange rate movements will act as shock absorbers, insulating each domestic economy from disparate external monetary movements, thus strengthening its capacity to pursue independent monetary-fiscal policies.

(2) This is because the nominal exchange rate and the price level will move oppositely, minimizing the short-term volatility of the real exchange and interest rates.

(3) International capital flows will cause real interest rates to converge globally, thus optimizing the global allocation of physical capital.

As the dollar shortages of the 1950s swung to dollar surpluses in the 1960s for the industrialized trading partners of the United States, and as dwindling United States gold reserves weakened the linchpin of the Bretton Woods system - dollar-gold convertibility at a fixed price - Friedman's position gained support. By the early 1970s it was, according to James Tobin, "the dominant one in the economics profession, though not among central bankers and private financiers."[3]

The demise of Bretton Woods in 1972 was followed by a rapid shift to flexible exchange rate regimes and the progressive freeing of the financial markets of the industrialized countries and of many developing countries from capital controls and other regulatory barriers to mobility. The consequences over the past two decades have, however, been unkind to Friedman's case; virtually none of his anticipations has materialized. Flexible exchange rates and financial liberalization have not improved allocative efficiency, reduced macroeconomic instability, or given individual countries a greater capacity to implement diverging national macroeconomic policies.

Empirical research has uncovered only two clear-cut efficiency gains. Increased international competition has virtually equalized bid-ask spreads on deposits in different Eurocurrencies, and the internationally-linked financial markets have been eliminating with incredible rapidity small differentials in the exchange rate adjusted price of short-term instruments of comparable maturity and risk.[4] In the language of economists, flexible exchange rates and financial liberalization have generated covered interest parity (CIP) on short-maturity instruments.

But these efficiency gains in finance have created inefficiencies in production and trade because, as Tobin pointed out to his professional compeers when the majority were still adherents to the Friedman position, "Goods and labor move, in response to international price signals, much more sluggishly than fluid funds. Prices in goods and labor markets move much more sluggishly than the prices of financial assets, including exchange rates."[5] Economists now agree that the exchange rate movements and financial flows of the past two decades have failed to meet Friedman's allocative efficiency criteria. In the language of economists, the movements and flows have produced neither uncovered interest parity (UIP), nor the international convergence of real interest rates, that is, real interest parity (RIP).

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[2] Milton Friedman, "The case for flexible exchange rates", in *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), pp. 157-203.

[3] James Tobin, "A proposal for international monetary reform", *Eastern Economic Journal*, vol. 4 (1978), p. 153.

[4] IMF, *Determinants and Systemic Consequences of International Capital Flows*, Occasional Paper No. 77 (Washington, D.C., March 1991), table 4 and charts 1 and 2.

[5] Tobin, *op. cit.*, p. 154. Tobin's last point may cease to hold in countries suffering from severe and extended inflation in which the rates of change of all prices tend to converge, though with further deterioration of productive efficiency.

The meaning of these parity relationships can be clarified with a little algebra. Let:

F = the forward exchange rate n-periods hence
S = the spot rate (home currency/foreign currency)
i = the home interest rate on securities maturing in n-periods
i^* = the foreign interest rate on similar securities

Then $d = (F-S)/S$ is the market's premium on the n-period forward exchange rate. CIP prevails if $d = i-i^*$.

UIP also prevails when "d" accurately predicts the actual change of the spot exchange rate. UIP is a necessary but not sufficient condition for the attainment of RIP. To see this, let:

r = the home country's real interest rate
r^* = the foreign country's real interest rate
X = the percentage change of the nominal exchange rate
P = the home rate of inflation
P^* = the foreign country's rate of inflation

If $r-r^* = (i-i^*-X) + (P^*-P+X) = 0$, RIP holds; real interest rates converge. For this to happen both parenthetical terms must sum to zero. The first goes to zero if UIP holds, that is, if $d=X$. The second term goes to zero if the exchange rate moves in inverse proportion to changes in the relative domestic purchasing power of the two currencies, that is, if $P^*-P = X$. This requires exchange markets to anticipate accurately future inflation rate differentials between the two countries; or, in economic terms, that the purchasing power parity (PPP) theory of exchange rate determination should be an accurate exchange rate predictor.

Economists assessing the many econometric tests made on industrial countries' data of the past two decades largely agree, however, on the following:[6]

(1) The forward exchange rate premium, "d", has been a poor predictor of future spot rates. UIP is not attained.

(2) Even CIP ceases to hold for instruments of more than a few months' maturity.

(3) Real exchange rates and real interest rates have moved about, at times violently, with no sustained tendency for the first to settle down or the second to converge internationally. It follows that PPP has been a poor predictor of short- and intermediate-term exchange rate movements, and not much better as a predictor of long-term movements.

(4) Exchange rate volatility has been considerably intensified by cross-border speculation in financial assets. That volatility in turn has augmented speculative opportunities, and so has tended to be self-reinforcing, susceptible to "band wagon effects" and to inflate into short- and medium-term financial bubbles.[7]

(5) The very rapid expansion of international financial flows during the past two decades was not matched by an accelerated growth of the volumes of international trade and international flows of physical capital.

(6) Hence, the global interlocking of national financial markets has far exceeded the global interlocking of national productive structures. The financing of national investment has remained dependent primarily on national capital accumulation.[8]

(7) The globalization of financial markets has, however, greatly diminished the macroeconomic policy autonomy of even dominant industrial economies like the United States. Exchange and asset price volatility have magnified rather than damped the impact of external turbulence on the national economies.

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[6] This summary draws primarily on Ronald MacDonald and Mark P. Taylor, "Exchange rate economics: a survey", *IMF Staff Papers*, vol. 39, No. 1 (March 1992), pp. 1-57; IMF, *Policy Issues in the Evolving International Monetary System*, Occasional Paper No. 96 (Washington, D.C., June 1992); and UNCTAD, *Trade and Development Report, 1990*, United Nations publication, Sales No. E.90/II/D/6, Part Two, chap. 1.

[7] MacDonald and Taylor, *op. cit.*, report two recent surveys of London foreign exchange dealers which show that, for time-frames of a month or less, over 90 per cent of the dealers relied on "charting", that is, on identifying patterns of price movements that purport to capture the psychology of market players rather than on econometric models or news about "fundamentals". The surveys also report that the "chartists" consistently outperformed econometric models in forecasting the dollar-sterling exchange rate.

[8] "... it has generally been found that the ratios of investment to income and savings to income have in practice been highly correlated, and this holds for both industrial and developing countries." IMF, *Determinants and Systemic Consequences of International Capital Flows*, *op. cit.*, p. 10.

On what is to be done, however, consensus among economists breaks down. Residual Friedmanites fall back on the contention that the above findings were obtained from data that were still contaminated by various government interventions, which is true; and that it can be shown theoretically that, in the absence of such interventions, the missing parities would show up and rescue Friedman's anticipations, which is not true. On the contrary, the cumulative efforts of economic theorists to explore rigorously the dynamic properties of a competitive laissez-faire economy with capital accumulation has pretty well established that stability is not one of its fundamental properties.

A fundamental reason for this is that the full array of futures markets required to enable long-term investors and lenders to hedge against all possible types of risks cannot logically be made a property of such an economy.[9] Necessarily investors and lenders must base their individual decisions on incomplete information about future prices and costs, filling in information gaps about the future with informed guesses that in the aggregate can put the economy on many possible time paths, depending on the diverse tea leaf and entrail readings on which the individual investors and lenders base their guesses about the uncertain future. The path may not be a stable one. If not, a crisis can ensue. Nor does experience of past crises necessarily improve the accuracy of the decisions, since a changing, accumulating economy also keeps changing the contours of the future. In the UIP case the data do not indicate that the accuracy of "d" as a predictor has improved with age.

At the opposite pole from the laissez-faire position is the "Keynesian" view that contamination of the economic data by government interventions is a logical imperative deriving from two inherent flaws of a laissez-faire economy with accumulation. The first is that individual agents are impelled to try to stabilize their profit streams by monopolizing and/or colluding with competitors and lenders in order to gain greater command over the uncertain future. Governments are therefore drawn in to adjudicate chronic conflicts between the static allocative efficiency of markets and their dynamic instability. They are also impelled to intervene because the stabilizing effectiveness of such market-monopolizing strategies is limited; they often have adverse "robbing Peter to pay Paul" spillovers on other markets, and are unable to contain economy-wide crises originating in the cumulative overshooting and misallocations to which long-term investors and lenders are prone.[10]

The majority of economists, however, now mill around between the above two poles. The empirical evidence cited earlier has wiped out their initial euphoria about the putative benefits of flexible exchange rates and financial globalization and reawakened interest in interventionist alternatives for stabilizing exchange and interest rates, but there has been no clear coalescing as yet around a specific set of interventionist policies.

Recent IMF policy papers mirror this state of affairs. The earlier IMF insistence on exchange rate devaluation as an essential instrument for eliminating chronic trade and current account deficits is now replaced by a menu approach, as indicated by the following quote from one of the papers:

> One of the central themes of this paper is that progress toward greater exchange rate stability can be achieved within a system in which exchange rate commitments are tailored to the characteristics and circumstances of individual countries. Thus each nonpolar country could remain free to choose between floating, fixing to a basket of currencies, fixing to one of the three key currencies, or even adopting one of the key currencies as its unit of legal tender.[11]

Such menus are, however, little more than refuges for the analytically perplexed when the links between policy and "characteristics and circumstances" are not clearly established. The perplexity in this instance arises from the two contradictory uses assigned the exchange rate by the prevailing policy line of the IMF and the World Bank. In the generalized market liberalization strategy promoted by these institutions, the function of the exchange rate is primarily to allocate resources; it should be free to move in order to equilibrate each country's markets for internationally traded goods. Generally, countries lifting tariffs and controls in these markets will need to devalue their real exchange rate in compensation.[12] On the other hand, in the stabilization strategy toward which the IMF and World Bank have recently been gravitating, the job of the exchange rate is primarily to serve as a stable anchor for the price level, which calls for stabilizing the price of the domestic currency in terms of the dollar or another of the key foreign currencies. Typically, as in Latin America during the late 1970s and again currently, this slows inflation by raising the real exchange rate at the cost of growing trade and current account deficits. The late Dutch economist, Jan Tinbergen, mathematicized the aphorism, "you can't kill two birds with one stone", into a well-known theorem that for a set of policies to be coherent the number of distinct policy instruments should equal the number of distinct policy objectives. The simultaneous use of the exchange rate as a reallocator of resources and as an anchor for the price level violates Tinbergen's coherence test.

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[9] The behavioural premise of the laissez-faire model, that all agents are utility maximizers and that risk and effort always generate disutility, would create extreme moral hazard problems, i.e. effort slackening, that would render infeasible most of the required futures markets.

[10] For a useful modelling of this position in a "chaos" theoretical format, see Piero Ferri and Hyman P. Minsky, "Market processes and thwarting mechanisms", *Jerome Levy Institute Working Paper No. 64* (Rhinebeck, N.Y.: Bard College, 1991). The quotation marks around "Keynesian" in the text are to indicate that there are also variants of Keynesian macroeconomics that have tried to marry Keynes' views about monetary economics and investor uncertainty with the neoclassical notion that in the longer run a competitive market economy always converges toward a full employment equilibrium. That this is faithful to Keynes' own position is questionable (see H.P. Minsky, *John Maynard Keynes*, New York: Columbia University Press, 1975). In the past two decades, this "Keynesian neo-classical synthesis" variant has been losing out among Keynesians to variants closer to the "Keynesian position" summarized in the text.

[11] IMF, *Policy Issues in the Evolving International Monetary System, op. cit.*, p. 9. This same "menu" approach appears in Bijan B. Aghevli, Mohsin S. Khan and Peter J. Montiel, *Exchange Rate Policy in Developing Countries*, Occasional Paper No. 78 (Washington, D.C.: International Monetary Fund, March 1991).

Coherence might be restored were monetary and fiscal policies alone able to do the stabilizing, leaving the exchange rate free to fluctuate in line with the resource allocative function assigned to it by the trade liberalization strategy. However, according to the IMF papers, the heightened financial mobility has greatly weakened the ability of national monetary and fiscal policies to achieve macroeconomic stability within a flexible exchange rate regime. International financial mobility has reinforced the power of financial markets to thwart monetary stabilization policies. It has also encouraged competitive tax-cutting and deregulation between countries and offshore tax sheltering that collectively helped to reduce government savings rates of industrial countries from 3.5 per cent of GDP in 1967-1973 to 0.3 per cent in 1980-1990.[13] Falling private savings rates have paralleled falling government savings, the gross savings to GNP ratio of the industrial countries declining from 26 per cent in 1973 to 20.5 per cent in 1988.[14]

Moreover, the IMF papers accept that private financial markets are inherently susceptible to band wagon effects and financial bubbles, and express concern at the increased threat of global financial crises that has accompanied the liberalization of financial markets and the globalization of finance. They note nine such crises of global or near-global scope between 1970 and 1989, six occurring in the 1980s. In all cases, lenders sharply raised their risk premiums and credit rationing, which spread illiquidity and augmented asset price volatility and the risk of default. All but one of the crises evoked central bank emergency intervention to halt the spread of financial distress.[15]

Accordingly, the papers support the efforts of the BIS countries to strengthen their prudential supervision of banks and to coordinate crisis management. The most recent of the papers urges an intensification of these efforts, warning that United States, British and Japanese banks, by resorting so aggressively to securitizing loans and other off-balance-sheet transactions in order to evade the recently heightened capital adequacy requirements, are contributing to the "growing opaqueness of the financial system", which is making it increasingly difficult for the central banks and other supervisory authorities "to assess fully the risk exposure of the entire consolidated balance sheet of financial institutions ... Indeed, it is widely recognized that without reforms in financial policy and close attention by central banks, the new financial system could resemble a new high-speed train attempting to run on old, ill-maintained tracks."[16]

Nor is fixing the exchange rate seen as a solution. "... the loss of monetary policy effectiveness will be greatest with a fixed exchange rate. Indeed, there is the question of whether the degree of capital mobility is currently so high as to have eliminated all vestiges of domestic monetary policy independence for countries with no capital controls and a fixed exchange rate."[17]

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[12] Demitris Papageorgiou, Michael Michaely and Armeane M. Chocksi (eds.), *Liberalizing World Trade* (published for the World Bank by Basil Blackwell, London, 1991), 7 vols., is a collection of World Bank-sponsored case studies of trade liberalization efforts around the world. The dominant conclusion of the editorial summation (see vol. 1) is that in the successful cases the lifting of trade controls was always accompanied by a substantial and sustained real devaluation.

[13] IMF, *Policy Issues in the Evolving International Monetary System, op. cit.*, table 8.

[14] Bijan Aghevli *et al., The Role of National Savings in the World Economy*, Occasional Paper No. 67 (Washington, D.C.: International Monetary Fund, March 1990).

[15] IMF, *Determinants and Systemic Consequences of International Capital Flows", op. cit.*, table 11.

[16] IMF, *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, D.C., September 1992), pp. 7-8.

The analysis would seem then to lead inexorably to the conclusion that whether the objective is to strengthen the effectiveness of monetary-fiscal stabilization policies in the industrialized countries, or to give logical coherence to the IMF-World Bank liberalization strategy for the developing countries, some curbing of international capital mobility has become a *sine qua non.*

But at this point the papers take a strange detour around that conclusion. The Tobin proposal (detailed in part III) to "throw some sand in the well-greased wheels" of the world financial markets by putting a uniform transaction tax on trades involving foreign exchange is given short shrift with the observation that to be effective it would need to be imposed on a global basis, since "if implemented in only a few markets, activity would quickly shift to other markets."[18] Globalizing the tax is dismissed, apparently as too demanding of international cooperation to be practical, whereas promoting global stability through the "coordination of fiscal policy with respect to some structural aspects including tax reform" is apparently not impractical.[19] The main difference seems to be that the transaction tax proposal is specific, hence politically controversial, whereas the broader proposal is vague and any sharp edges can be muffled in platitudinous qualifications such as the following elaboration of the proposal for fiscal coordination:

> This is not to suggest that international coordination should occur at the expense of sound national fiscal policies, or that countries should make international commitments that preclude major domestic fiscal reforms. Coordination or harmonization of fiscal characteristics should not compromise good policies and move away from the best tax and regulatory practices. Nor is it intended to suggest that tax and regulatory competition is always bad.[20]

We have reproduced the platitudes, at perhaps some embarassment to the authors, to emphasize two points related to the proposals presented in part III. One is that skilled IMF analysts have to contain their policy advice within political parameters set by their institution, however intellectually frustrating that may be. The second is that since their analysis proper clearly indicates that constraining international capital mobility would be a global public good, the G-24, in trying to change the political parameters at the IMF so as to make constraining that mobility an acceptable topic for technical policy analysis, would be pushing against a weakly-latched door.

II. International financial mobility and the developing economies

The destabilizing effects of international financial mobility on the industrial economies impact the developing country economies even more severely. The greater vulnerability of developing country economies to exchange rate volatility and other external financial shocks is indicated by the data in tables A-1 and A-2. The adverse effects of the globalization of finance on developing country fiscal policy are manifest in the capital flight data of table A-3.

Table A-1 compares the month-to-month exchange rate volatility, since the demise of Bretton Woods, of 12 major developing countries with those of Germany and Japan. The developing countries, which are from the three continents of the "South," differ considerably in structure, extent of market liberalization, terms-of-trade trends and political stability. This is reflected in the average percentage movements of their exchange rates: lowest in the Asian countries and highest in the Latin American countries throughout the period, with the African countries in between, though with Nigeria and Zambia rising toward Latin American levels of exchange rate movement in the 1980s. But while the average movements of only four of the 12 developing countries exceeded those of the two industrialized countries, the coefficient of variation columns of table A-1 show that eight of the 12 developing countries had higher coefficients, that is, larger oscillations around their average movements, than did either Germany or Japan.[21] Most telling are the last two columns of the table, which show that the interplay between exchange rate and price level changes was much closer in all 12 developing countries than in Germany and Japan; the developing countries were much less able to dampen the feedbacks from exchange rate volatility to the price level than were the industrialized countries.

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[17] IMF, *Determinants and Systemic Consequences of International Capital Flows, op. cit.*, p. 27.

[18] *Ibid.*, p. 37.

[19] IMF, *Policy Issues in the Evolving International Monetary System, op. cit.*, p. 26

[20] *Loc. cit.*

Table A-2 shows that in the 1980s the substantial real exchange rate volatility of the three key industrialized countries was exceeded by almost all of the Latin American and Caribbean countries. The "Lost Decade" is one in which the adverse fundamentals of the region should have forced up the real exchange rates, and this indeed shows up in table A-2 for most of the countries, providing rough validation of the purchasing power parity (PPP) theory as a predictor of long-term exchange rate movements. But the more recent declining trend of the real exchange rate indicated for many of the countries - their 1991 rate is well below their peak year rate - has been paralleled in most cases by rapidly rising trade and current account deficits.[22] This does not conform to the PPP theory's prediction, nor does it suggest that the volatility of the real exchange rate is likely to decline for those countries.

The inability of developing economies to handle external shocks easily should hardly come as a surprise. As one of the recent IMF policy papers put it:

> The consensus of opinion regarding the shock-absorbing properties of an economy is that the costs of fixing the exchange rate are likely to be inversely related to the degree of factor mobility, the flexibility of wages and prices, and the extent to which the economy has a diversified industrial structure. By parallel logic, the extent to which exchange rates are likely to fluctuate in a floating regime will be inversely related to the degrees of factor mobility, industrial diversification and wage-price flexibility.[23]

That is, the lesser economic development of developing countries causes their economies to be less able to adjust smoothly to destabilizing shocks whether under fixed or fluctuating exchange rate regimes.

The estimates of capital flight from 15 highly-indebted developing countries presented in table A-3 highlight the adverse fiscal as well as monetary aspects of international capital mobility for these countries. The foreign debt of the 15 countries rose 317 per cent between 1978 and 1988, but capital flight from these countries rose even more, as indicated by the third column of the table. A substantial portion of the foreign debt prior to the outbreak of the developing country debt crisis in 1982 had been accumulated by private developing country firms and banks, but after the crisis broke the debtor governments were forced under pressure from the creditors to assume, *ex post facto*, the responsibility for servicing private foreign debts, in effect, to socialize them.

For many of the governments, the added debt servicing increased their fiscal burden very substantially, while the concurrent capital flight shrank their tax base, resulting in sizeable increases of their fiscal deficits. Moreover, the exchange rate depreciation substantially raised the domestic currency cost of servicing the foreign debt, which tended further to increase fiscal deficits. Funding the deficits by the sale of government notes meant bidding against the less risky foreign securities that were attracting the flight capital. In thin developing country financial markets, this forced up domestic real interest rates to untenable levels, crowding out domestic physical investment, and setting off a spiralling of debt service and fiscal deficit. The alternative of monetizing the deficits through central bank financing damped that spiralling but accelerated inflation, capital flight and exchange depreciation.[24]

Table A-3 also shows that, by 1987-1988, total private foreign assets (claims) of the 15 countries, which are the estimated stock of recorded private foreign assets plus cumulative unrecorded capital flight, had risen to two thirds of the foreign debt. Indeed, an apparent inconsistency in the estimating methodology used by the IMF suggests the size of the claims may be understated.[25] Regardless of this, the annual repatriation of the income from even the volume of claims reported in table A-3 would have greatly reduced devaluation pressures in the debtor countries, thus easing money market interest rates and fiscal expenditures for servicing the foreign and domestic debt. On the revenue side, taxes on the full foreign income could have augmented total tax revenues by perhaps 5 to 10 per cent.[26]

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[21] The coefficient of variation is the standard deviation divided by the average.

[22] Inter-American Development Bank, *Economic and Social Progress in Latin America, 1992 Report* (Washington, D.C.: Johns Hopkins Press, 1992), appendix tables D-1 and D-2.

[23] IMF, *Policy Issues in the Evolving International Monetary System, op. cit.*, p. 16.

[24] This has been elaborated on the basis of the experiences of the heavily-indebted Latin American countries, in "Debt crisis adjustment in Latin America: have the hardships been necessary?", in Robert Pollin and Gary Dymski (eds.), *New Directions in Macroeconomics: Essays for Hyman P. Minsky* (University of Michigan Press, forthcoming).

[25] The explanation of the methodology is rather obscurely worded in the source of the table A-3 estimates. But it appears that, while the net stock of recorded claims is obtained by capitalizing the private investment income, other than from direct foreign investment, recorded in the country's balance of payments statistics, the unrecorded claims are merely

The policy advice of the IMF papers to the developing countries is, however, astonishingly at odds with their factual analysis. The advice takes the volatility of international capital flows and the ability of the affluent classes of those countries to evade capital controls and domestic taxation of their foreign assets as irremediable policy constraints, and urges the developing countries to adapt their macroeconomic stabilization policies accordingly. Each developing country is advised to stabilize its price level and exchange rate and to balance fiscal budgets, while lifting the remaining controls on interest rates and capital flows, as well as lowering taxes on interest, profits, dividends and property sufficiently to induce capital repatriation and attract foreign investment.[27] That is, developing countries are expected, their weaker and less-flexible economic structures notwithstanding, to accomplish what industrialized economies, according to the same IMF analysts, have not been able to achieve individually, namely, macroeconomic stability through orthodox monetary-fiscal policies in the context of liberated domestic and international financial markets.

Nor do the papers foresee a rapid and sustained increase of private capital inflows to developing countries that are implementing the IMF's stabilization package. Rather they forecast slow, uneven re-access of the developing countries to international capital markets - especially slow for the highly-indebted among them - with the debt instruments carrying high risk premiums, or special "enhancements" that transfer the exchange and default risks to the borrower.[28]

This retreat to realism is supported by the data of tables A-4 to A-7. The first table shows that, while the developing country share of medium- and long-term credits from international capital markets had risen in the last three years, the 1991 share was still well below that of 1984, which was itself a depressed year compared to the peak years of the developing country borrowing binge. In undeflated United States dollars, the combined flow of voluntary and "concerted" lending in 1984 was barely below 1991; in deflated dollars it was much higher. Table A-5 shows that during 1985-1991 about half the flow was to Asian developing countries, with almost all the rest divided nearly equally between European developing countries plus former Soviet bloc countries and Western Hemisphere developing countries, and with African and the non-oil Middle East countries virtually "out of the loop." Table A-6 shows that most of the developing country bonds floated internationally during the past three years were for maturities of five years or less and, when not formally collateralized by accessible external assets, carried very high risk premiums and/or enhancements. Table A-7 shows that the securities of the majority of the developing countries evaluated by Moody's have junk bond ratings. There is also no detectable correlation in table A-7 between the zealousness with which IMF-type policies are being pursued and the bond ratings. The bonds of dirigiste countries like China and the Republic of Korea share investment grade ratings with two relatively free market economies; India lost its investment grade rating in the course of intensifying its IMF-type liberalization; the three Latin American countries zealously pursuing IMF strategies share junk bond status with less zealous Brazil, etc.

IMF expectations about capital flight repatriation are also muted. The IMF view is, "since the residents of developing countries probably want to hold internationally diversified portfolios, it is unlikely that all previous flight capital would return even with 'good' policies."[29] Thus the anti-egalitarian tax and

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an estimate of cumulative capital flight. This implies that the flight capital earns no income that is reinvested abroad. If we allow the flight capital to be augmented by reinvestment abroad, as seems eminently reasonable, total private external claims as well as the size of the unreported share are augmented.

[26] Tax revenues totalling 13 per cent of GNP are roughly representative for these countries. If foreign claims averaged about two thirds of the foreign debt, which in turn averaged about two thirds of GNP, the claims would be about 45 per cent of GNP. Assume the annual income from the foreign assets is 10 per cent, or 4.5 per cent of GNP, and that 77 per cent of the income has not been reported or taxed. Taxing that income would add almost 3.5 per cent of GNP to the tax base. If the relevant income tax rate is 20 per cent, total tax revenues rise by 5.4 per cent; if the rate is 30 per cent, tax revenues increase by 8 per cent, etc.

[27] This summarizes the policy advice in IMF, *Determinants and Systemic Consequences of Capital Flows*, *op. cit.*, p. 43. See also Donald J. Mathieson and Liliana Rojas-Suárez, "Liberalization of the capital account: experiences and issues", *IMF Working Paper* No. 92/46, 1992, for similar advice to developing countries.

[28] IMF, *Determinants and Systemic Consequences of International Capital Flows*, *op. cit.*, pp. 39-42.

[29] *Ibid.*, p. 43.

monetary inducements to flight capital owners to bring it back, which clash with the egalitarian tax and expenditure reforms needed to implement the "growth with equity" objective that the IMF and World Bank have been emphasizing in their recent normative rhetoric, are expected to produce a rather moderate payoff in capital repatriation. An assessment of whether the capital repatriation inducements are reconcilable with the "growth with equity" objective and, if so, how they are to be reconciled, would therefore appear to be necessary. Nevertheless, the reconciliation problem is neither raised nor is advice on how to resolve it proffered.

Unfortunately, the inconsistencies between the IMF's analysis and its policy advice to developing countries are overlooked in the 1992 communiqué of the G-24. Point 24, which "called on the governments in developing countries to provide an enabling environment to attract FDI flows and encourage the repatriation of flight capital" and "... for innovative mechanisms to facilitate the flow of private funds to developing countries"[30] is an unqualified IMF policy. It addresses neither the inconsistencies with "growth with equity" nor with the need to curb destabilizing hot money flows. The latter inconsistency is again ignored by Point 10, in which the G-24 "restated their view that the industrial countries and the Bank for International Settlements should review and improve supervisory practices and regulations in order not to unduly constrain the banks in industrial countries from lending to developing countries, through additional conditions that reduce voluntary credit and investment flows, including new money."[31] Point 10 disregards the international public good accruing from the strengthening of BIS prudential supervision and information gathering, and overlooks opportunities for developing countries to enlarge on these efforts so as to ease their own monetary and fiscal stabilization problems. Part III below presents alternative proposals for consideration by the G-24 for collaboration between industrialized and developing countries that could redress the balance.

III. Reducing the destabilizing effects of capital mobility on the developing economies: some proposals for the G-24

Collectively, the proposals outline new mechanisms and changes in existing ones that could increase the net benefits to developing economies from international capital mobility by curbing its destabilizing effects, such as excessively volatile short-term flows and tax evasion through capital flight, while keeping the channels for long-term flows open. This requires industrial country collaboration, but since the problems addressed are shared in varying degree by all countries, collaboration on the following proposals ought not to be ruled out as hopelessly utopian.

A. *An internationally uniform transaction tax on foreign exchange transactions*

As proposed by Nobel Laureate James Tobin 15 years ago, the tax would have the following structure:[32]

(1) It would have a uniform rate and be applied, at the least, by all the key currency countries.

(2) The tax would be administered by each government on *all* payments by residents within its jurisdiction that involve a spot currency exchange, including in the case of Eurocurrency transactions, exchanges that do not involve the home currency.

(3) Proceeds from the tax would be paid into a central fund, controlled by the IMF or World Bank.

(4) With IMF consent, small industrialized countries and developing countries that are formally part of currency areas, or have tied their currency to one of the key currencies, could be exempted from the tax.

Tobin saw the tax as an effective way to "throw some sand in the well-greased wheels" of the international financial market mechanism[33] or, in Keynes' well-known phrase, "to mitigate the predominance of speculation over enterprise." As the uniform tax as a percentage of expected yield falls heaviest on "short-term financial round-trip excursions into another currency," and lightens the longer the foreign asset is held before the funds are repatriated, the tax would substantially reduce the post-tax profitability of short-term currency speculation while merely pinpricking foreign direct investment and other long-term capital flows.[34]

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[30] *IMF Survey*, 26 October 1992, p. 335.

[31] *Ibid.*, p. 334.

[32] Tobin, *op cit.*, p. 154.

[33] *Ibid.*, p. 158.

Since Tobin first advanced his proposal, his target, currency speculation, has expanded phenomenally; the dollar value of transactions in the world foreign exchange markets now averages over 30 times the dollar value of international trade in goods and services. With disturbing frequency enormous financial flows have been redirected from relatively benign arbitraging of ephemeral interest and exchange rate anomalies to gang attacks on vulnerable currencies in pursuit of large speculative payoffs. As a result, industrial country policy circles are looking at transaction tax possibilities with growing interest. *The Economist* recently concluded an accolade of the 1978 Tobin article outlining his proposal with the comment that "Lately, one imagines, a good many government economists have been dusting down their copies of that article."[35]

Apart from favourable spillovers to the developing countries from the greater macroeconomic stability that a tax along the lines of the Tobin proposal might bring the industrialized countries, the tax offers the following direct benefits to the developing countries:

(1) It would help to deter capital flight by increasing its transaction costs.

(2) The tax receipts centralized in the IMF or World Bank could, if rechanneled appropriately as credits to developing countries, be a welcome offset to the slackening of other official loans and transfers from the industrial countries.

(3) It would mitigate the "financial Dutch disease" that intermittently afflicts developing economies.

To expand on the last point: "financial Dutch disease" refers to a situation in which excessive short-term financial inflows appreciate the real exchange rate to the extent of undermining the government's export-oriented growth strategy, while also augmenting the money supply to the extent of undermining its stabilization strategy.[36] The situation is thus the obverse of the destabilizing macroeconomic feedbacks from a depreciating exchange rate that a burst of capital flight often generates. Developing countries are more susceptible to the "disease" than industrialized countries because their productive structures are more narrowly based and adapt less easily to external shocks, and because their thinner financial markets are less able to muffle domestic asset-price volatility, when impacted by external capital inflows and outflows.

Developing countries trying to disinflate by anchoring their price level to a fixed or slowly depreciating exchange rate expose themselves to the "disease" because the spread between nominal domestic and foreign interest rates will remain sizeable. This creates juicy arbitrage prospects which foreign speculative capital - including returning flight capital - will exploit if persuaded that the developing country has the foreign exchange resources as well as the political strength to sustain its exchange rate policy long enough to make round-tripping in short-term domestic financial assets, such as government notes, a low-risk venture. In that case, the inflow becomes self-reinforcing by adding to the developing country's foreign exchange supply, which extends the low-risk condition, but also activates "financial Dutch disease" symptoms.

Developing countries committed to market liberalization are especially vulnerable. The abjuring of direct controls on capital, foreign exchange and imports to counter the symptoms leaves them mainly with monetary sterilization instruments, such as the open market sale of government securities, to neutralize the monetary effects of the capital inflow. But, when pushed very far, such sterilization tends to become counterproductive by sending up home interest rates and widening the interest rate spread, which then attracts even more arbitraging foreign capital. It also requires the central bank to sell higher interest domestic currency notes in order to neutralize an accumulaton of foreign exchange reserves that yield the lower foreign interest rate, weakening the central bank's balance sheet. The main "cure" tends, therefore, to come from the appreciating real interest rate. As it appreciates, foreign exchange is increasingly siphoned off to cover a growing trade deficit, which in time erodes the financial market's confidence in the further sustainability of the exchange rate policy, slowing and often reversing the short-term flows.

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[34] Assume a 1 per cent tax per currency exchange and $1 million to be invested. If the investment is turned over weekly through foreign currency round-tripping, the annualized tax is $1,040,000; a monthly turnover reduces the annualized tax to $240,000, it falls to $20,000 if the turnover is yearly, to $4,000 on a five-year turnover, and so on.

[35] *The Economist*, London, 3 October 1992, p. 71.

[36] The term "Dutch disease" was originally applied to the adverse feedback to Dutch industry of the Netherland's natural gas export bonanza of the early 1970s, which pushed up the international price of the guilder, cheapening imports and squeezing non-gas exports. The term was soon generalized to apply to any primary export boom whose exchange rate effects substantially squeeze the profitability of domestically produced traded goods. "Financial Dutch disease" is a further extension to situations in which the squeeze is initiated by an upsurge of financial inflows rather than a primary export boom.

Whether the cure is worse than the disease depends on whether or not the disease terminates in explosive capital flight. A relatively benign denouement is possible if the other determinants of profit margins in the country's traded goods sector are favourable enough to offset a considerable amount of profit squeeze from the appreciating real exchange rate. Such beneficent fundamentals - often in developing countries the result of upturns in international prices for the country's exports - also provide room for the unilateral application of transaction taxes or equivalents to reduce net profits from the interest rate arbitraging without setting off an explosive capital exodus. In the past year or so, Chile and Colombia have used such measures with some success to slow short-term capital inflows and the real exchange rate appreciation.[37]

Unilateralism is risky, however, when the fundamentals are less beneficent. Thus Argentina, currently afflicted with an especially virulent case of financial Dutch disease, is now so dependent on speculative capital inflows to protect the linchpin of its stabilization strategy - a dollar exchange rate frozen by law - that it dare not risk slowing the inflow. The Government is forced, therefore, to rely on anti-egalitarian policies, such as wage repression and cuts in welfare taxes and benefits to offset the growing squeeze from the steeply falling real exchange rate on profit margins in the traded goods sector. Despite these offsets and the incessant chanting of free market mantras by government spokesmen to reassure capital markets, Argentina may well be headed for an explosive cure of its financial Dutch disease.

The Argentine case implies that for the transaction tax to help disparate developing countries reduce the virulence of the Dutch disease, the tax should be globalized. It also suggests that Tobin underestimated the required scope of the globalization when he suggested that countries that have tied to a key currency may not need the tax. The current speculative runs on the weaker ERM currencies indicate the same for regional currency areas. Indeed, the European Community, which lifted intra-Community capital controls in 1990, is now discussing the establishment of uniform withholding and transaction taxes within the Community.[38]

To sum up, the G-24 should propose a serious joint exploration with the G-7 on the feasibility of a uniform transaction tax on exchange transactions. The G-24 should take the lead in proposing it for two main reasons. Firstly, the relative benefits for developing countries are probably even greater than for the industrialized countries.[39] Secondly, the financial firms of the major industrial countries that have been feasting on financial volatility are likely to be especially resistant to a stabilizing transactions tax.[40] This makes initiating a transaction tax proposal especially dangerous for policy makers of the major industrial countries concerned for their career longevity. The G-24 may thus be in a strategic position to resolve "a bell the cat" dilemma. Putting the transactions tax proposal, now informally viewed with interest by some industrial country policy makers, on the table in an official G-24 communiqué could make it politically easier for these policy makers to pursue the proposal officially.

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[37] Inter-American Development Bank, *op. cit.*, pp. 14, 60-62, 68-69.

[38] IMF, *Determinants and Systemic Consequences of International Capital Flows, op. cit.*, p. 30.

[39] In this regard, the G-24 should not take as conclusive the IMF assertion that a transactions tax "may ... discourage trades based on fundamentals" (*loc. cit.*, p. 37). The IMF also accepts that reducing the high financial volatility of recent years may encourage international trade and investment by reducing producer and investor uncertainty (*Policy Issues in the Evolving International Monetary System, op. cit.*, pp. 20-22). Since the two "mays" are offsetting, the net effect is indeterminate.

[40] A Wall Street banker observes: "A more controversial feature of the new shape of the financial system is that the bulk of its participants now have a vested interest in instability. This is because the advent of high-technology dealing rooms has raised the level of fixed costs. High fixed costs imply a high turnover for profitability to be achieved. High turnover tends to occur only when markets are volatile." J. Walmsley, *The New Financial Instruments: An Investor's Guide* (New York: John Wiley & Sons, 1988), p. 13; as cited in Andrew J. Cornford, "Notes on a possible multilateral framework for international trade in banking services", *UNCTAD Discussion Paper* No. 28 (April 1990).

B. *Using collaborative bank supervisory mechanisms to reduce capital flight and tax evasion on foreign assets*

The globalizing of financial crises accompanying the globalizing of finance has motivated since 1975 a series of collaborative agreements between the central banks of the larger industrial countries to tighten supervision of bank operations. Initially, the agreements were only between the 12 member countries of the Basle Committee on Banking Regulation and Supervisory Practices (hereinafter the Basle Committee),[41] and focused on tightening and standardizing prudential bank regulations to reduce the danger of cascading bank crises, by providing for more complete reporting requirements from banks with offshore subsidiaries and branches, clarifying supervisory jurisdictions between the countries hosting these units, and tightening and standardizing the capital requirements for banks in general. International bank fraud and the use of international banks for laundering drug money and as repositories of illegal funds in the 1980s have become additional motives for the collaborative strengthening of regulations. The agreements between central banks via the Basle Committee are being supplemented by direct intergovernmental agreements, initiated by the United States, to tighten bank regulations on record keeping and client identification and to broaden the exchange of information between government agencies.

Involved have been two contrasting dynamics. Financial market liberalization and "deregulatory competition" have been facilitating the ability of banks and financial markets to evade national controls, whereas the increased susceptibility of the liberated financial systems to cross-border crises and their increasing use as vehicles for cross-border illegal activities, have been impelling the deepening and internationalizing of controls. The Basle Committee has had a full range of problems to deal with since its first Concordat, issued in 1975 in response to the 1974 Herstatt crisis.[42] In tightening supervisory standards, the subsequent Concordats and supplementary regulations have drawn additional countries into the regulatory networking. So also have the recent United States-led efforts to prevent the use of international banks for illegal money laundering. The task force set up at the Economic Summit of the Group of Seven in July 1989 "to assess the results of cooperation already undertaken in order to prevent the utilization of the banking system and financial institutions for the purpose of money laundering, and to consider additional preventive efforts in this field, including the adaptation of the legal and regulatory systems so as to enhance multilateral judicial assistance", includes three non-Basle Committee countries - none, however, a developing country.[43]

Yet, in all this there are missed opportunities for developing countries to use these developments to gain better control over two interrelated problems of their own with international banks: their inadequate "governability" over the local branches and subsidiaries of large multinational banks, and the ease with which these local affiliates function as conduits for capital flight and other evasionary activities. Both problems are rooted in the fact that the local affiliates are units of large complex international intrafirm networks that offer many channels for the affiliates to elude local bank regulations and controls. This gives the multinational banks a comparative advantage over the smaller domestic developing country banks in moving clandestine funds internationally.

Among their most common strategems has been to provide firms and wealthy nationals of developing countries with "private banking" facilities for moving funds out of the country, and equally confidential facilities for engaging in various types of "back-to-back" loans.[44] In back-to-back loans, the borrower uses his private foreign deposits at the bank to collateralize a loan of equivalent size issued by the local bank affiliate, the loan interest rate being a markup on the deposit interest rate. The loan may be in local or foreign currency as the borrower wishes. In almost all cases the borrower's objective is to profit by evading monetary or fiscal laws and regulations. If local interest rates have been pushed higher by the authorities to slow inflation, a back-to-back loan in local currency gives the borrower a preferential interest rate. The juiciest payoffs, however, have come from using foreign currency back-to-back loans for exchange rate speculation during financial crises. In the Argentine crisis of the early 1980s, for example, firms with foreign debts were allotted dollars by the central bank for debt servicing at a preferential exchange rate. This created a triple payoff to the borrower from back-to-back loans in dollars. Since the spread between the loan's interest rate and the crisis rate on peso loans had widened enormously, back-to-back dollar borrowing was a relatively cheap way to obtain pesos as needed by reselling dollars. On declaring the loans to the central bank, the borrower also established a future claim for dollars at a preferential rate to service that loan, most of which he could resell at a considerable profit in the local foreign exchange market, since most of the service was in fact covered by the interest earned on foreign deposits collateralizing the loan. Finally, the full interest charge on the back-to-back loan was deductible from taxable income as a business expense.[45]

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[41] Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and United States.

[42] The crisis involved the failures of the I.D. Herstatt Bank of Germany and the Franklin National Bank of the United States. The vector of international contagion was the sizeable interbank deposits of banks with unsupervised Eurocurrency operations. The interest-bearing deposits were a more profitable way of maintaining liquidity than keeping reserves with the home central bank. The Herstatt crisis showed that they were also susceptible to panickly withdrawals by banks during crises.

[43] UNCTAD, *Trade and Development Report, 1992*, United Nations publication, Sales No. E.92.II.D7, p. 87. Part Two, annex I, of this report is an excellent detailed account of the Basle Committee's efforts, on which my brief summary draws heavily.

[44] For a more detailed description, see Karen Lissakers, *Banks, Borrowers and the Establishment: A Revisionist Account of the International Debt Crisis* (New York: Basic Books, 1991), chap. 6.

However, the recent tightening of collaborative supervision is drastically curtailing bank secrecy. In the United States, banks under section 4702 of the 1988 Anti-Drug Abuse Act are now required to ascertain the true identity of clients involved in large international and domestic financial transfers. United States banks must also now keep five years of records and identifying documents. Since the passage of the Act, the United States has negotiated a tentative agreement with 14 other countries, including Switzerland, to impose the same requirements on their banks. Switzerland has recently enacted money laundering legislation under which the failure of a bank to take adequate steps to identify third-party beneficiaries of bank intermediation is a criminal offense, and in the spring of 1991 abolished numbered bank deposit accounts.[46]

The Basle Committee has supplemented the United States' efforts by endorsing the following statement of ethical standards for banking practice:[47]

> Firstly, banks should make reasonable efforts to determine the true identity of customers using any of their services; secondly, banks should ensure that laws and regulations pertaining to financial transactions are adhered to and high ethical standards are observed, withholding their services in the case of transactions believed to be linked to money laundering; thirdly, within the constraints of customer confidentiality banks should cooperate fully with national law enforcement agencies; and, fourthly, banks should adopt policies with regard to matters covered by the Basle Committee's statement which are designed to ensure that staff adhere to the principles which it contains. Changes in national legislation and regulation required for the practical application of these principles is [sic] left to the Governments of the Basle Committee's member countries.[48]

In response to the BCCI scandal, the Basle Committee in July, 1992 also issued the following set of recommendations to further tighten international bank supervision:[49]

(1) The home country banking authority should have the power to prevent banks from establishing offshore banking offices and affiliates that in the authority's judgement are likely to undermine the effectiveness of prudential supervision.

(2) The creation of a cross-border establishment should require the prior consent of both the host country and the home country supervisory authorities. Consent should be conditional on an agreement between the two authorities to provide access to all information required by each of the authorities for effective supervision.

(3) The host country authority should be empowered to impose such restrictive measures on the foreign bank affiliate as it deems needed to satisfy its prudential concerns. It should also be obliged to perform

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[45] *Ibid.*, pp. 149-151. The foreign banks rejected as outrageous the request of the first post-military Treasury Minister, Bernardo Grinspun, for the names of back-to-back borrowers, since it asked them to violate their confidentiality pledge. (Information on this obtained from my interview with Dr. Grinspun, April 1991.)

[46] Lissakers, *op. cit.*, pp. 157-158.

[47] Committee on Banking Regulations and Supervisory Practices, *Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering* (Basle, December 1988).

[48] *Trade and Development Report, 1992, op. cit.*, pp. 86-87.

[49] Basle Committee on Banking Supervision, 'Minimum standards for the supervision of international banking groups and their cross-border establishments' (Basle, July 1992). The summary and evaluation above are based on Andrew J. Cornford, 'A note on the July 1992 statement of the Basle Committee on banking supervision' (unpublished internal UNCTAD document).

adequate supervision of the affiliate on a "stand alone" basis if necessary.

These offer promising opportunities for developing countries to strengthen governability over international bank affiliates, and to restrain their use as vehicles for clandestine capital flight and tax evasion. However, they require developing countries to make use of these opportunities and to begin to participate in shaping the ongoing collaborative efforts at international bank supervision. There are ambiguities in the Basle Committee's recommendations concerning the scope of the rubrics "prudential" and "money laundering." From the developing country perspective, they should be broadened to include illicit evasion of taxes and capital controls, and the Basle Committee recommendations on the supervision of new cross-border affiliates should be extended to cover existing cross-border banking affiliates. Left to themselves, the responses of the industrial countries to such unsettled issues will no doubt be shaped by their own governability requirements; the developing countries ought to try to get the responses reshaped to accord more closely with *their* governability needs.[50]

Accordingly, the G-24 might consider including the following proposals in its future communiqués.

(1) Recommend that developing countries that are pressed by the major industrial countries to remove restrictions on the entry of multinational banks should insist that all such entries be conditional on the following:

  (a) that each petitioning bank formally contract to adhere faithfully to the Basle Committee's December 1988 recommendations on bank ethics in all its host country activities, the contract also authorizing that

    (i) the supervisory authorities of the host developing country may apply penalties, including closure, for contract violations;

    (ii) the bank and/or its home country may appeal the penalties to the World Court, but must accept its judgement as final, and agree not to engage in any unilateral retaliation against the host country prior to or after the Court's ruling.

  (b) In accordance with the Basle Committee's July 1992 recommendations on the exchange of information between home and host bank supervisory authorities, the home country shall agree to make best effort responses to all requests for information about the activities of the multinational bank from the host developing country's supervisory authority that it deems needed for adequate supervision of the activities of the bank's local affiliate.

(2) The G-24 should urge the Basle Committee to extend its 1988 and 1992 recommendations:

  (a) to cover tax fraud;

  (b) to cover the activities of existing as well as new cross-border operations of multinational banks;

  (c) to expand the Committee to include representatives of regional developing country supervisory groups, such as the South-East Asia, New Zealand and Australia group and the Commission of Supervisory Authorities of Latin America and the Caribbean.

(3) The G-24 should urge these regional groups to develop coherent group positions on how to improve their members' governability of the cross-border banking affiliates they host. The purpose is to:

  (a) educate members on using the existing international facilities to strengthen governability;

  (b) instruct their representatives on the Basle Committee, should it be enlarged in accordance with the G-24's proposal;

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[50] Nor should the developing countries expect the industrial countries to vigorously enforce the Basle Committee's existing recommendations for the developing countries' benefit without active prodding. The relative participation of offshore centres in the financial flows of the industrialized countries diminished during the 1980s, presumably reflecting both the more rigorous prudential and fiscal controls discussed in the text and increased domestic banking deregulation (see, IMF, *International Capital Markets*, September 1992, tables 5, A13 and A14). There is, however, anecdotal evidence that the offshore centres remain useful in the intermediation of capital flight funds by United States and European banks. Miami banks still set up shell corporations in some Caribbean offshore financial haven to help affluent Latin Americans disguise the ownership of their deposits in those banks. The main response of the banks to the ethical injunctions and supervisory tightening seems to have been to minimize the paper trail; they now orally direct their Latin customers to Miami law firms for setting up the shell companies rather than perform the service in-house. United States authorites have been proscribing such activities only when drug or other criminal money is involved.

(c) negotiate with the Basle Committee on governability matters on behalf of their members, should formal membership be rejected.

C. *Using the exchange of tax information agreements*

Since 1988 the United States has been promoting bilateral agreements for the exchange of tax information with various Latin American and Caribbean countries. The explicit objective, as stated in the United States-Peru agreement (included in the appendix to this paper) is as follows:

> The Government of the Republic of Peru and the Government of the United States of America, desiring to assure the accurate determination and collection of taxes, to prevent tax fraud, and to develop better sources of information for tax matters, and understanding the need for mutual collaboration for the purpose of penalizing violations of public and social norms relating to tax evasion, have agreed to provide each other assistance through the exchange of information, as provided in this Agreement for the Exchange of Tax Information.

The Agreement covers all taxes due the respective central governments by individuals, businesses and other "legal persons" domiciled within their national borders and offshore possessions. The tax enforcement authorities of the two countries are obligated to fully comply with each other's requests for information concerning earnings and assets owned within one signatory country's borders that are subject to tax by the other signatory. Article 4 of the Agreement indicates that the obligation extends well beyond providing information in the files. It also includes performing additional searches and hearings, in which agents of the requesting government may participate. Requests for information under the Agreement take precedence over prevailing confidentiality laws and practices of banks and other fiduciary institutions and agents. Indeed, even without a specific request, the tax enforcement authority of each country is enjoined to be, in effect, a whistle blower, i.e. to forward any information "which has come to its attention which is likely to be relevant to ... the determination, assessment, and collection of tax, the recovery and enforcement of tax claims, as well as the investigation or prosecution of tax crimes or crimes involving the contravention of tax administration" in the partner country.

The United States may have been pushing these bilateral agreements primarily as an adjunct to its anti-drug trade efforts. But for a developing country signatory concerned to curb tax evasion through capital flight, the reciprocal and comprehensive language of the agreement usefully supplements the opportunities created by the improvements in international bank supervision in at least three ways. It engages the help of foreign tax agencies which can supply information on income and assets squirreled away with the connivance of other institutions than banks. Security houses and international law firms, as well as banks with operations in the signatory developing country that have also been active in setting up offshore shell companies and trusts for clients from that country may be deterred from continuing that activity by the increased risk of exposure and penalty.[51] The developing country negotiating such an agreement could insist that it also enjoin the signatory governments from issuing securities, such as bearer bonds, that invite capital flight for the purpose of tax evasion. Accordingly, the G-24 should consider including the following in its future communiqués:

(1) The current developing country signatories should strengthen their existing laws on the taxing of foreign assets as required in order to make full use of the opportunities to collect such taxes provided by the Agreement.

(2) The Agreements should be amended to specifically enjoin the signatory governments from issuing bearer bonds or other instruments that facilitate tax evasion.

(3) Other developing countries within the United States orbit should seek similar agreements with the United States, strengthening their tax laws appropriately to maximize fiscal benefits.

(4) The G-24 should also propose a convention to multilateralize the tax agreements, with convention signatories - industrial and developing country - agreeing to negotiate a standardized agreement with one another.

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[51] This point is especially emphasized in a legal evaluation of a similar Agreement to exchange tax information between the United States and Mexico. See Michael Karlin and Paula Breger, "The U.S. and Mexico agree to exchange tax information", *International Financial Law Review*, March 1990.

D. *Concluding observations on the purpose and acceptability of the proposals*

These proposals are not meant to be substitutes for serious fiscal and monetary stabilization efforts. Rather, they are intended to provide the conditions needed to make such stabilization efforts succeed. They accord with article VI, section 3, of the IMF Articles of Agreement, which states that "Members may exercise such controls as are necessary to regulate international capital movements" provided the measures used do not conflict with the member's commitment to article VIII, which requires the member to maintain currency convertibility for current transactions. They are also in accord with the premonitions of the Bretton Woods designers of the Articles of Agreement, arising from their interpretation of the turbulent interwar experience, that uncontrolled capital flows would undermine their primary objective: a stable, liberal post-war trading world. In this they appear to have been right.

The collaboration of the major industrial powers, notably the United States, is crucial to most of the proposals. Is that at all likely? Mutual benefits are to be obtained by both industrial countries and developing countries from most of the proposals, but probably not enough to gain acceptance from the industrial countries, were they to respond according to the parochial self-interest that was ideologically acceptable in the Reagan-Thatcher era. Perhaps yes, if they take a broader view of their self-interest so as to include mutual longer-term benefits from neighbourliness. The following recollection of the contrasting responses to capital flight during the Marshall Plan and Reagan-Thatcher eras provides some hopeful evidence that this is possible.[52]

European capital flight during the 1940s was almost entirely to the United States, as was Latin American capital flight in the 1980s. The ideological reaction to and treatment of flight capital was, however, quite different. In the debates over the Marshall Plan hostility was directed at the owners of the assets, capsulized in the assertion by Republican Senator Henry Cabot Lodge that "in a lot of these countries it is a well-known fact that there is a small, bloated, selfish class of people whose assets have been spread all over the place and that that is a very bad thing for the morale of those countries and it is a bad thing for the morale over here." In the so-called "Washington Consensus" of the 1980s, by contrast, the "class of people with assets" were merely blameless victims of the bad policies of their governments.

The Marshall Plan included a clause requiring any government receiving aid to locate and put to appropriate use the foreign assets of its citizens; it was a compromise clause that followed a prolonged, heated debate, in which Wall Street, operating through the Treasury, barely managed to stave off proposals to forceably repatriate the European assets. One of the more moderate proposals came from the World Bank. It called for the forceable exchange of European flight capital for World Bank bonds, to be used to finance European reconstruction. This appealed to Herbert Hoover, who testified that "if there is a protest that taking over these privately held resources is a hardship to the owners, it may be pointed out that the alternative is a far greater hardship for the American taxpayer." The Chairman of the Federal Reserve System also argued in favour of forced repatriation of the assets, stating that "the question was whether this government was going to protect the private rights of foreign citizens as against the efforts of their governments to survive." In the 1980s, by contrast, the United States Government sought to induce more capital flight by abolishing in 1984 the withholding tax on interest income from United States deposits and securities held by foreigners and by issuing in 1985, United States Treasury bearer bonds, a historic first for the Treasury.

The moral foundations of capitalism have thus supported varying views on equity and the scope of the public interest with regard to capital flight. With the Reagan-Thatcher era perhaps fading out, equity considerations and a broader view of the public interest may be coming back again. The ideological winds may be turning favourable for launching the suggested proposals in the next G-24 communiqué.

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[52] The author summarizes here Eric Helleiner's excellent paper, "Capital flight and the receiving country: contrasting US policy in the Marshall Plan and the 1980s debt crisis", presented at the Annual Meeting of the Canadian Political Science Association, 31 May - 2 June 1992.

Table A-1

MONTHLY NOMINAL EXCHANGE RATE AND PRICE LEVEL VOLATILITY OF SELECTED DEVELOPING COUNTRIES AND INDUSTRIALIZED COUNTRIES, 1973-1990

	Average absolute exchange rate change		*Coefficient of variation*		*Average CPI change/ exchange rate change*	
	1973-1980	*1981-1990*	*1973-1980*	*1981-1990*	*1973-1980*	*1981-1990*
	(Percentages)		*(Ratios)*		*(Ratios)*	
Africa						
Nigeria	0.64	3.81	1.64	3.53	3.01	0.55
Côte d'Ivoire	2.19	2.70	1.08	0.79	0.92	0.44
Kenya	0.90	1.65	1.97	1.30	1.31	0.54
Zambia	1.13	8.46	2.77	2.92	1.07	0.84
Sample average	1.22	4.16	1.87	2.13	1.58	0.59
Asia						
India	1.73	1.18	0.80	0.85	1.18	0.76
Indonesia	0.57	1.09	9.05	4.80	2.76	0.67
Korea, Republic of	0.58	0.62	3.72	0.85	3.39	0.86
Philippines	1.28	1.20	0.62	3.39	5.63	0.81
Sample average	1.04	1.02	3.55	2.47	3.13	0.78
Latin America						
Argentina	8.00	20.53	2.83	2.42	1.01	0.81
Brazil	2.94	15.53	1.39	1.23	1.06	0.90
Chile [a]	7.22	2.10	1.71	1.91	0.95	0.76
Mexico	1.40	4.50	4.91	2.37	1.15	0.96
Sample average	4.89	11.84	2.71	1.98	1.04	0.91
Industrial countries						
Germany	2.47	2.71	1.40	1.25	0.17	0.10
Japan	2.07	2.74	1.49	1.26	0.45	0.22

Source: For developing countries: computed from data in IMF, *International Financial Statistics* (various issues). For industrial countries: IMF, *Policy Issues in the Evolving International Monetary System*, Occasional Paper No. 96 (Washington, D.C., 1992), table 9.

[a] 1974-1980.

Table A-2

ANNUAL VOLATILITY OF REAL EXCHANGE RATES OF LATIN AMERICAN, CARIBBEAN AND KEY CURRENCY COUNTRIES DURING 1980-1991 [a]

(1980 = 100)

	High year	*Low year*	*1991*	*High year/low year ratio*
I. Latin America and the Caribbean				
Argentina	317.3	100.0	172.6	3.17
Bolivia	155.2	33.8	150.1	4.59
Brazil	147.8	93.5	115.4	1.58
Chile	193.6	82.3	187.6	2.35
Colombia	195.8	84.9	189.5	2.31
Costa Rica	176.3	100.0	176.3	1.76
Dominican Republic	193.7	95.7	140.6	2.02
Ecuador	236.6	87.9	212.0	2.69
El Salvador	100.0	62.9	67.5	1.59
Guatemala	170.5	83.8	145.6	2.03
Guyana	226.8	65.1	226.8	3.48
Honduras	145.2	80.2	145.2	1.81
Jamaica	169.5	90.7	169.5	1.87
Mexico	157.5	84.2	109.9	1.87
Panama	135.1	91.7	135.1	1.47
Paraguay	196.3	81.5	169.8	2.41
Peru	106.0	28.8	28.8	3.68
Trinidad and Tobago	100.6	59.0	99.8	1.71
Uruguay	164.9	80.2	144.0	2.06
Venezuela	215.3	81.6	201.8	2.64
Regional average	175.2	78.4	149.4	2.23
II. Key currency countries				
Germany	106.4	76.9	76.9	1.38
Japan	125.0	75.8	87.0	1.65
United States	142.9	71.4	137.0	2.00
Key country average	124.8	74.7	100.3	1.67

Source: Inter-American Development Bank, *Economic and Social Progress in Latin America, 1992 Report* (Washington, D.C.: Johns Hopkins University Press, October 1992), table 3; and IMF, *Policy Issues in the Evolving International Monetary System*, *op. cit.*, chart 4.

[a] Foreign currency/domestic currency ratios.

Table A-3

CAPITAL FLIGHT, EXTERNAL PRIVATE CLAIMS AND FOREIGN DEBT OF HIGHLY INDEBTED DEVELOPING COUNTRIES[a]

(Billions of dollars)

	Capital flight[b] *(1)*	*Foreign debt* *(2)*	*Capital flight to debt* *(1)/(2)*	*Private external claims*[c] *(3)*	*Capital flight to claims* *(1)/(3)*	*Private claims to debt* *(3)/(2)*
1978	47.30	113.70	0.42	71.62	0.66	0.63
1979	64.14	141.76	0.45	92.17	0.70	0.65
1980	75.41	179.06	0.42	119.41	0.63	0.67
1981	85.16	224.26	0.38	134.16	0.63	0.60
1982	99.95	261.30	0.38	142.57	0.70	0.55
1983	123.77	285.70	0.43	164.13	0.75	0.57
1984	136.43	301.05	0.45	182.52	0.75	0.57
1985	147.54	311.60	0.47	199.70	0.74	0.61
1986	152.67	326.39	0.47	210.30	0.73	0.64
1987	180.62	349.75	0.52	233.73	0.77	0.67
1988	184.01	360.43	0.51	239.14	0.77	0.66

Source: Liliana Rojas-Suárez, "Risk and capital flight in developing countries", table 1, in IMF, *Determinants and Systemic Consequences of International Capital Flows*, Occasional Paper No. 77 (Washington, D.C., March 1991).

[a] Argentina, Bolivia, Chile, Colombia, Ecuador, Gabon, Jamaica, Mexico, Nigeria, Peru, Philippines, Venezuela and Yugoslavia.

[b] Net *unrecorded* stock of capital outflows less the *unrecorded* stock of capital inflows. *Recorded* stock of capital flows estimated by capitalizing the private foreign income and debt servicing reported in the country's balance of payments accounts.

[c] External claims are the sum of net recorded foreign claims, other than foreign investment, of nationals plus an estimate of their net stock of unrecorded foreign claims.

Table A-4

MEDIUM- AND LONG-TERM INTERNATIONAL CAPITAL MARKET CREDITS, 1984-1991

	1984	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*
I. $ billion								
All credits [a]	184.2	246.6	308.8	294.0	364.0	385.2	358.4	417.0
To developing countries [a]	21.2	17.2	15.4	10.1	12.4	17.8	22.8	34.8
To ex-Soviet bloc countries	2.6	3.9	2.8	3.2	3.9	4.2	4.9	1.6
II. Per cent distribution of all credits								
A. By type								
Bonds	59.4	68.0	73.5	60.6	62.4	66.4	64.1	71.4
Syndicated bank credits [a]	24.9	14.6	17.0	27.9	33.0	31.4	33.9	27.1
Underwritten facilities [b]	15.7	17.4	9.5	11.5	4.6	2.2	2.0	1.5
B. By region								
To developing countries	11.5	7.0	5.0	3.4	3.2	4.2	6.1	8.3
To ex-Soviet bloc countries	1.4	1.6	0.9	1.1	1.1	1.1	1.4	0.4
To advanced economies	87.1	91.4	94.1	95.5	95.7	94.7	92.5	91.3
Memo item								
"Concerted" bank loans [c] ($ billion)	11.1	7.1	--	9.5	5.1	--	3.0	0.1

Source: UNCTAD, *Trade and Development Report, 1992*, United Nations publication, Sales No. E.92.II.D.7, table 9.

[a] Excluding "concerted" bank loans.

[b] Multiple-component facilities, note issuance facilities and other international facilities underwritten by banks, but excluding merger-related stand-bys.

[c] New bank credits extended in the context of debt restructuring agreements.

Table A-5

INTERNATIONAL CAPITAL MARKET FLOWS TO DEVELOPING REGIONS, 1985-1991

(Millions of dollars)

	1985	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*
Africa [a]							
Bonds	520	126	49	433	159	0	0
Money market	n.d.	n.d.	n.d.	n.d.	0	0	0
Bank credit	1,500	1,800	700	600	500	600	400
Total	2,020	1,926	749	1033	659	600	400
Asia							
Bonds	6,005	2,915	2,411	2,631	2,218	3,113	3,555
Money market	n.d.	n.d.	n.d.	n.d.	935	2,295	605
Bank credit	7,500	8,200	8,500	7,800	8,900	12,000	13,400
Total	13,505	11,115	10,911	10,431	12,053	17,408	17,560
Europe [b]							
Bonds	510	457	866	2,438	3,434	2,343	2,156
Money market	n.d.	n.d.	n.d.	n.d.	100	0	100
Bank credit	6,400	4,900	5,600	4,800	4,100	4,900	1,700
Total	6,910	5,357	6,466	7,238	7,634	7,243	3,956
Middle East [c]							
Bonds	60	0	0	0	0	0	0
Money market	n.d.	n.d.	n.d.	n.d.	0	0	0
Bank credit	300	100	300	200	700	100	0
Total	360	100	300	200	700	100	0
Western hemisphere [d]							
Bonds	169	712	350	877	0	1,154	4,648
Money market	n.d.	n.d.	n.d.	n.d.	396	0	1,550
Bank credit	2,400	8,500	2,700	6,400	4,600	3,000	2,500
Total	2,569	9,212	3,050	7,277	4,996	4,154	8,698
All developing regions [d]							
Bonds	7,311	4,210	3,711	6,399	5,811	6,610	10,696
Money market	n.d.	n.d.	n.d.	n.d.	1,831	3,165	2,755
Bank credit	19,200	24,800	17,900	20,000	19,500	20,500	18,000
Total	26,511	29,010	21,611	26,399	27,142	30,275	31,451

Source: IMF, *International Capital Markets: Developments, Prospects and Policy Issues* (Washington, D.C., September 1992), tables A23, A24 and A25.

a Excluding South Africa.

b Including the former USSR and other Eastern bloc countries.

c Excluding Israel and oil-exporting Gulf States.

d Excluding offshore bank centres.

Table A-6

AVERAGE TERMS OF RECENT INTERNATIONAL BOND ISSUES OF SELECTED DEVELOPING COUNTRIES

	1989			1990			1991 [a]		
	Amount $m	*Per cent*	*Maturity years*	*Amount $m*	*Per cent*	*Maturity years*	*Amount $m*	*Per cent*	*Maturity years*
I. New entrants									
Argentina									
Private (U)	--	--	--	21	7.3	5.0	15	5.0	1.5
Public (U)	--	--	--	--	--	--	300	5.1	2.0
Brazil									
Public (U)	--	--	--	--	--	--	925	5.2(E)	3.6
Chile									
Public (U)	--	--	--	--	--	--	200	2.1	5.0
Mexico									
Secured [b]	385	1.7	5.0	1297	3.0	4.4	570	1.5	5.0
Public (U)	100	8.2(E)	5.0	905	3.8(E)	4.9	1170	2.5	4.2
Private (U)	150	8.0(E)	2.0	182	6.1(E)	3.6	720	5.4	4.4
Venezuela									
Secured [c]	--	--	--	60	2.5	5.0	--	--	--
Public (U)	263	1.9	7.0	130	2.6	5.0	150	2.4	5.0
Private (U)	--	--	--	75	6.9	5.0	--	--	--
II. Earlier entrants									
Algeria									
Public (U)	200	1.5	5.0	100	1.0	5.0	--	--	--
Bulgaria									
Public (U)	130	1.6	7.0	--	--	--	--	--	--
Czechoslovakia									
Public (U)	--	--	--	470	1.0	5.0	--	--	--
Hungary									
Public (U)	600	1.1	8.4	810	1.4	6.0	670	2.3	6.0
India									
Public (U)	460	1.0	7.1	290	1.3	7.0	240	1.4	5.0
Turkey									
Public (U)	1235	1.9	8.4	615	1.7	6.2	230	2.4	5.0
Private (U)	20	1.6	4.0	--	--	--	--	--	--

Source: Alessandro Leipold *et al.*, *Private Market Financing for Developing Countries* (Washington, D.C.: International Monetary Fund, December 1991), tables 8 and A-17.

Note: Amount = bond issues in millions of dollars. Per cent = the per cent yield premium over the prevailing yield on industrialized country bonds of the same currency denomination and maturity. Maturity = maturity of bonds in years. Secured = bond issues formally collateralized by external assets. U = bond issues not formally collateralized by external assets. E = enhanced bonds; when half or more of the bonds in the group are enhanced with various options to reduce lenders' risk.

[a] January-September.

[b] Average of public and private bond issues.

[c] Private bond issue.

Table A-7

CREDIT RATING BY MOODY'S INVESTORS SERVICE OF SELECTED DEVELOPING COUNTRY BORROWERS, 1991

Investment grade			
Republic of Korea	A1	Malaysia	A3
Thailand	A2	China	Baa1
Below investment grade			
Hungary	Ba1	India	Ba2
Venezuela	Ba1	Brazil	B2
Mexico	Ba2	Argentina	B3

Source: Leipold *et al.*, *op. cit.*, table 9.

Note: •Only investment grade bonds are eligible for the portfolios of pension funds and other fiduciary institutions. Baa is Moody's lowest investment grade rating.

•India's rating was downgraded from A2 to Baa1 in October 1990 and Ba2 in June 1991.

•Hungary's rating was downgraded from Baa2 to Ba1 in July 1990.

•Venezuela's rating was upgraded from Ba3 to Ba1 in July 1991.

SELECTED INTERNATIONAL POLICY ISSUES ON PRIVATE MARKET FINANCING FOR DEVELOPING COUNTRIES

Edmar L. Bacha

Executive Summary

1. After a decade of stagnation, a small but important group of middle income developing countries, mostly in Latin America, has witnessed a remarkable turnaround in access to private finance, led by a dramatic increase in gross portfolio investment flows, almost trebling to $21 billion in 1991, compared to 1989. For 1992 the projected figure was around $27 billion. The boom in private capital inflows has given rise to new considerations of macroeconomic and financial management for economic policymakers in the developing countries. The first question is how best to manage the macroeconomic effects of large capital inflows manifested in terms of real exchange rate appreciation and the monetary implications of substantial reserves accumulation. The second concern is how to hedge against the dislocation that could follow changes in external financial conditions and a sudden withdrawal of the flows. Beyond such concerns, for the developing countries as a group, it is important to design international economic policies which might help render these new capital inflows more sustainable or less speculative as well as reaching a larger group of recipient countries.

2. Action by the international community is particularly needed now that, under a new administration, the United States of America appear to be on the path to a recovery which should improve its domestic investment prospects but increase short-term interest rates, thus tending to attract developing countries' "flight capital" back to their off-shore bases.

3. The recommendations in this paper for international action to strengthen and make sustainable the international capital flows to developing countries are divided into four groups, addressing respectively: the multilateral decision-making process, the industrialized countries, the international financial institutions, and the problems of small and low-income developing countries without access to private capital markets.

***Multilateral decision-making**. (a) The Group of Seven is the centrepiece of multilateral economic policy-making. The time is ripe to include a developing country delegate in Group of Seven deliberations. This step would considerably help in implementing certain policy actions discussed below. (b) Foreign direct investment (FDI) is one of the most interesting forms of external private financing for developing countries: the establishment of a multilateral FDI facility, official debt relief, and opening the industrial country markets to imports from the developing and transforming economies would significantly affect the climate for direct investment inflows to these countries. (c) The Paris Club is a cumbersome institutional mechanism for restructuring official debt contracts: an official debt agency linked to the Bretton Woods institutions could replace it at a profit to both developing and industrialized countries. (d) The massive amounts and high volatility of short term capital flows sometimes poses insurmountable difficulties to economic policy makers of industrialized and developing countries alike: serious consideration should be given to the imposition of transaction taxes on trades in short-term securities, as a possible remedy for the flows of hot money.*

***Industrialized country domestic policies**. (a) One means of increasing the external resources that could be made available to developing countries would be to increase the level of public sector savings in the industrialized countries. (b) It would be important to act on measures both to reduce fiscal deficits and to expand the access of developing countries to the domestic financial markets in the industrialized countries. Among the regulatory changes needed to achieve the latter objective would be: graduation from loan loss regulatory provisioning regimes; determination of appropriate risk-weights for computing banks' adherence to regulatory capital adequacy requirements; and flexibility in the use of cut-off credit rating standards and other regulatory restrictions for mobilizing funds on industrialized country securities markets.*

***International financial institutions**. Recommendations for new actions by international financial institutions include: (a) establishment of a currency convertibility facility jointly sponsored by the International Monetary Fund and the Bank for International Settlements; (b) a facility to provide new debt enhancement through collateralization and other financial techniques; (c) measures to improve the quality of developing countries' risk assessment by international financial markets; and (d) technical assistance to developing countries on financial engineering and domestic financial market reform.*

Small and low income countries. *Most developing countries, whether because they are too small or too poor or both, cannot realistically expect to benefit from long-term private capital inflows. The external financing problem of these countries includes a major debt overhang and can only be dealt with on the basis of substantially increased official flows.*

This paper surveys selected international policy measures which might contribute to the sustainability of recent capital inflows to some middle-income developing countries. The policy recommendations are divided into four groups, addressing respectively the multilateral decision-making process, the industrial countries, international financial institutions, and the problems of the small and low-income developing countries without access to private capital flows.

Introduction

After a decade of stagnation, a small but important group of middle income developing countries, mostly in Latin America, has witnessed a remarkable turnaround in access to private finance. This was led by a dramatic increase in gross portfolio investment flows, almost trebling to $21 billion in 1991, compared to 1989; the figure projected for 1992 was around $27 billion. By aggregate volume portfolio flows now exceed net flows of official finance for middle-income countries, reflecting the growing dominance of the private sector in international finance. A sharp increase in foreign direct investment (FDI) has also been observed, to a projected $38 billion in 1992 on a net basis (from $24 billion in 1990), thus extending its strong upward movement since the mid-1980s.[1]

The boom in private capital inflows has raised new issues for economic policy-makers in the developing countries concerning macroeconomic financial management. The first question is how best to manage the macroeconomic effects of large capital inflows manifested in terms of real exchange rate appreciation or the monetary implications of substantial reserves accumulation. The second concern is how to hedge against the dislocation that could follow changes in external financial conditions and a sudden withdrawal of these flows.[2]

Beyond such concerns, for the developing countries as a group, it will be important to design policies, at both the domestic and international levels, which would contribute to make these new capital inflows more sustainable, less speculative as well as reaching a larger group of recipient countries.

There is a tendency in the Washington community, as reflected for example in recent IMF official reports, to assume, first, that "the causes of the inflows to Latin America and Asia are largely domestic and reflect development in the economies of these regions;[3] and secondly, that the key to sustained inflows is "to persevere with domestic market reforms to increase the attractiveness of developing country securities to foreign investors."[4] *Contrario sensu*, Calvo, Leiderman and Reinhard (1992a) point out that, while domestic reforms are necessary to encourage capital inflows, they can only partially explain Latin America's forceful re-entry in international capital markets. For instance, domestic reforms alone do not explain why substantial capital inflows are occurring in countries that have not undertaken substantial reforms - such as Brazil - nor why they occurred only recently in countries where reforms had been introduced long before 1990 - such as in Chile. Calvo *et al.* then proceed to a careful statistical analysis to substantiate their guarded conclusion that "some of the renewal of capital inflows to Latin America is due to external factors, like recession in the United States and lower international interest rates ... From a historical perspective then, the present episode may well be an additional case of financial shocks in the Center that affect the Periphery.[5]

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[1] For detailed information on the new capital flows to developing countries, see World Bank (1992). For the case of Latin America, see El-Erian (1992) and Griffith-Jones, Marr and Rodriguez (1992).

[2] On these topics, see Akyüz (1993), Bacha (1993), Calvo, Leiderman and Reinhart (1992a), Collyns *et al.* (1992), El-Erian (1992), Fry (1992), Fischer and Reisen (1992), Griffith-Jones and Culpeper (1992), Griffith-Jones, Marr and Rodriguez (1992), Jaspersen (1992), Mathieson and Rojas-Suárez (1992) and Szymczak (1992).

[3] *Cf.* IMF (1992, p. 37).

[4] *Cf.* Collyns *et al.* (1992, p. 32).

Sustainability of capital inflows will thus depend not only on the course of domestic policies in developing countries but also on international economic policies, as adopted by multilateral forums, the industrialized countries, and the international financial institutions. The next section surveys selected international policy measures which might contribute to sustaining the capital inflows to developing countries. The final section summarizes the recommendations.

I. International policy actions

This survey of recommendations for international policy actions designed to strengthen the inflow of foreign capital to the developing countries is divided into four parts. The first comprises decisions concerning the multilateral economic policy-making machinery. The second deals with the economic policy-making process in industrialized countries. The third addresses the actions of the international financial institutions. The fourth treats the cases of the small developing countries and the low income countries which remain without access to international financial markets.

A. *Multilateral economic policy-making*

Recommendations under this rubric include decisions related to developing countries' representation in the Group of Seven, a multilateral foreign direct investment facility, an international official debt restructuring agency, and an international tax on short-term capital flows.

1. *Developing country representation in the Group of Seven*

The Group of seven is the most important focus of international macroeconomic policy coordination in the world, but macroeconomic policy issues of direct interest to developing countries are only marginally taken into account in this forum. Moreover, the increased trade and financial openness of developing countries are transforming many of them (the larger countries, as a matter of fact, as well as the smaller ones to the extent that they join regional groupings) into relevant players in the international economic arena. It may be the right time to pressure the industrialized countries to include developing country representation in Group of Seven international policy coordination. This would in particular facilitate the consideration and implementation of the recommendations which follow.

2. *Multilateral foreign direct investment facility*

In the context of the Enterprises for the Americas Initiative, the Inter-American Development Bank recently established two facilities - the Investment Sector Loan Program and the Multilateral Investment Fund - respectively designed to provide adjustment loans to countries committed to removing impediments to investment and fostering open investment regimes, and to facilitate the adoption of comprehensive investment reforms. The European Community had launched in September 1988 the Investment Partners facility, designed to enable participating developing countries to realize the potential of foreign direct investment (FDI) in their development process.

In view of the importance of FDI as a source of sustainable externally financed growth in the developing countries, and of the relative success already attained by the meritorious but limited efforts of the Inter-American Development Bank and the European Community, the UN proposed in a 1992 report (United Nations, 1992, pp. 287-291) the establishment of a multilateral FDI facility with a view to assessing loans to developing countries to promote development through FDI. Such a facility would comprise a capital investment fund and a fund through which other activities would be financed. The capital investment fund would provide credit to developing countries for the establishment of export processing zones, science parks, service parks and similar facilities that help attract FDI to a country. Finance for other activities would cover technical assistance, information activities, the preparation of country assessment studies and the establishment of contacts between potential foreign investors and host country firms. A special window of the facility could deal with promotion of outward FDI by TNCs from developing countries.

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[5] *Cf.* Calvo, Leiderman and Reinhart (1992, pp. 1-2).

Other international measures designed to facilitate the inflow of foreign direct investment into developing countries would be as follows:

(a) ***Official debt relief***. Heavily indebted low and middle-low income countries and the former CMEA countries and republics of Eastern Europe may find it particularly difficult to attract foreign investment in the face of considerable uncertainty about the extent to which earnings will be taxed, given the current and prospective budgetary difficulties of these countries. One important way to improve the climate for capital inflows, according to Dooley and Isard (1992), would be to reduce the sources of prospective strains on fiscal budgets, thereby reducing fears of higher effective tax rates on capital income. In this context official debt relief could play an important role in reducing such fiscal strains, thus opening the way for foreign investment inflows.

(b) ***Open markets***. A factor that significantly affects the climate for direct investment inflows, as pointed out by Dooley and Isard (1992), is the perceived attitude of the industrialized countries toward opening their markets to imports from the developing and the transforming economies. For example, a clear invitation to other Latin American and Caribbean countries besides Mexico to join eventually the North American Free Trade Area, and a similar invitation for the transforming Eastern European and former Soviet economies to join eventually the European Community, could significantly stimulate foreign direct investment flows into export-oriented activities in the developing countries concerned - particularly if the invitations were accompanied by a commitment on the part of NAFTA and the EC to keep trade barriers low in the interim.

3. *International official debt restructuring agency*

Deploring the absence during the debt crisis of a legal mechanism similar to the Chapter XI proceedings under the United States bankruptcy law, Williamson (1992) proposed the creation of a debt agency linked to the Bretton Woods institutions, which could provide a mechanism for the revision of international debt contracts. Such an agency would act essentially as a mediation and conciliation institution, with legal powers confined to those needed to impose on dissenting creditors revised terms agreed by the debtor and a qualified majority of its creditors. Alternatively, an agency might take the form of a tribunal with the power to award debt relief through arbitration even against the wishes of the majority of creditors. Such a tribunal would need to base awards on agreed criteria as to the circumstances in which a country should be entitled to debt relief. These criteria would serve as an incentive for lenders to behave responsibly, as well as help identify circumstances in which efficiency considerations would indicate a need for debt relief.

Williamson's proposal has been criticized by Fukao (1992) who pointed out that the government of a defaulting country cannot be treated like a defaulting company because the former enjoys sovereign immunity. The implication is that Williamson's scheme could be made operative only if developing countries' Governments were prepared to yield their sovereign rights to an international debt tribunal, a rather unlikely prospect. If they did not, however, such a debt agency would simply become a debt relief agency, perhaps not altogether a bad idea for clearing up the debris of the last international debt crisis, but hardly a harbinger of substantial private capital inflows into the developing countries in the near future.

There seems, however, to be a broad consensus - as noted by Griffith-Jones, Helleiner and de Vries (in Teunissen, 1992, p. 118) - that the Paris Club machinery for resettling official debt contracts has become rather awkward and outmoded, and that new agile institutional machinery is badly needed. In this context, if both creditor country and debtor country Governments were willing to surrender their sovereign prerogatives to a new international debt agency (a not improbable move in such a symmetrical situation where both parties are sovereign), Williamson's proposal might be a welcome replacement to the Paris Club.

Once in place, a new official debt restructuring agency could serve as a natural international locus for early recognition of any eventual future debt crisis involving private creditors. Following events in the 1980s, it took too long for the international community to recognize that liquidity was only the visible tip of the debt problem of the developing countries, partly for lack of an appropriate international forum where the emerging insolvency problem could be properly evaluated by an independent third party.

4. *International taxation of short-term flows*

High volatility and massive amounts of short-term international capital flows sometimes pose insurmountable difficulties for economic policy-making by industrialized and developing countries alike. It is in this context that Gerry Helleiner, in comments to Griffith-Jones and Culpeper (in Teunissen, 1992, pp. 56-57), has proposed submitting these short-term capital flows to systems of monitoring and surveillance similar to those adopted for money flows related to the illicit narcotic drug trade.

At a minimum, an improved system of international statistical information should be developed to measure adequately big volatile capital flows. Proper measurement may, however, require clear identification of both parties to the capital flow. This could pose problems in countries where customer identity and banking secrecy are overly protected. In the end, an international convention may be necessary, along the lines of the December 1988 Basle Committee's statement of principles concerning money laundering. That statement was directed at four aspects of banking operations: first, that banks should make reasonable efforts to determine the true identity of customers using any of their services; secondly, that banks should ensure adherence to laws and regulations pertaining to financial transactions and observe high ethical standards, withholding their services in the case of transactions believed to be linked to money laundering; thirdly, within the constraints of customer confidentiality, banks should cooperate fully with national law enforcement agencies; and, fourthly, banks should ascertain that their staff observes the above principles. Banking secrecy and customer confidentiality are potential impediments to the achievement of the objectives enshrined in these principles. It is, nevertheless, noteworthy that the task force of 15 countries established to combat money laundering by the Economic Summit of the Group of Seven in July 1989 not only endorsed the Basle Committee's statement, but also urged banks to notify law enforcement agencies of suspicious activities by their customers. Implementation of the latter recommendation would require changes in the laws concerning banking secrecy in many countries. The same Economic Summit also decided in favour of the convening of a financial action task force with the mandate "to assess the results of cooperation already undertaken in order to prevent the utilization of the banking system and financial institutions for the purpose of money laundering, and to consider additional preventive efforts in this field, including adaptation of the legal and regulatory systems so as to enhance multilateral judicial assistance."[6] Such measures are specifically aimed at curbing the illicit drug trade, but it would be in the best interests of the international community, and particularly of the developing countries' Governments, to extend them to cover capital flight associated with illegal activities and tax dodging.[7]

In this context, measures leading to international harmonization of tax treatment of nonresidents' deposits would appear to be a priority topic for developing country Governments. Equally important would be a serious international discussion of the oft-cited but never implemented 1978 Tobin proposal for an international transfer tax on foreign-exchange transactions. Such a tax hopefully could be designed to make short-term currency speculation less attractive without much harming long-term international investment. Interest in this tax has recently intensified as a consequence of the turbulence in European foreign exchange markets since September 1992. A working group of officials of the Group of Seven has apparently been created to consider the feasibility of instituting international controls as a possible remedy to deal with flows of hot money.[8]

B. *Industrialized countries' domestic policies*

Industrialized countries' domestic policies could critically affect the availability of capital flows to developing countries in at least two respects: public sector savings and regulation of domestic financial markets.

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[6] For more details on the work of the Basle Committee on Banking Supervision, see UNCTAD (1992, pp. 79-94).

[7] On capital flight from developing countries, see Helleiner (1992), Rojas-Suárez (1992) and Salenkhou (1992).

[8] *Cf. The Economist* (1992).

1. Increased public sector savings

One means of increasing the external resources that could potentially be made available to developing countries would be to increase the level of public sector savings (or decrease the level of public sector dissavings) in the industrialized countries. The extent to which a reduction in these fiscal deficits would increase the resources available to developing countries depends on the latters' access to international financial markets.[9] If their access remained limited, a reduction of fiscal deficits would result not only in lower interest rates but also in a decline in industrialized countries' GDP, which would in turn curb developing countries' exports. Thus, in order to guarantee maximum benefit, it would be important to act on measures both to reduce fiscal deficits in industrialized countries and to expand the access of developing countries to their domestic financial markets.

2. Financial market regulatory changes

The re-entry of developing countries in the financial markets of the industrialized world poses a challenge to financial market regulators and supervisors as to how to meet genuine prudential concerns for protecting the integrity of their financial systems, while implementing sufficient regulatory flexibility to avoid undue credit rationing or excessive borrowing costs for developing country borrowers. El-Arian (1992) - noting that similar issues arose in the context of the Brady Plan, when regulators worked closely with debtors and creditors to clarify the applications of regulatory rules and, where appropriate, provide guidelines on the treatment of specific issues as they arose - has identified the following regulatory moves that could positively influence the nature of private market flows to developing countries:

(a) ***Graduation from loan loss regulatory provisioning regimes.*** Several industrialized countries' regulatory authorities require, as an element of prudential policy, that banks maintain loan loss provisions against loans to a wide range of developing countries that have previously defaulted or whose debt has recently been restructured. In making new loans to such borrowers, banks would normally be required to increase their level of reserves, which would raise the cost of lending. This requirement does not apply to nonbank investors. In several industrialized countries, regulatory provisioning requirements are determined by backward looking factors (particularly reschedulings and/or arrears) and tend to respond with a lag to a recovery in debtors' prospects (typically involving a five-year rule). An example of increased flexibility, which could be followed by other countries, is provided by the Canadian system, where the Superintendent of Financial Institutions may at his/her discretion remove a country from the provisioning list two years (rather than the standard five years) after the most recent rescheduling if the country has shown ability to raise funds of over one year maturity on international capital markets. Another example is the United Kingdom system, which bases provisioning decisions on a matrix that incorporates leading indicators of countries' creditworthiness. By contrast, Japan maintains a five-year minimum period since the most recent event of restructuring of default. Belgium and France have not established procedures for "graduating" borrowers from the provisioning requirements. Finally, in some countries, such as Germany, provisioning is encouraged by favourable tax treatment of provisions. As a result, many banks have in practice actually exceeded their regulatory provisioning requirements. Hence, there is scope for modifying regulatory regimes that discourage the holding of bank claims on countries re-entering international markets. Collyns *et al.* (1992) identify the following specific actions. First, in certain regimes more flexibility can be introduced in setting provisions by asset type, taking into account payment history, extent of security, and other factors. In particular, short-term trade related claims and interbank credits are likely to carry a lower risk than unsecured medium and long-term loans. Project lending, where special arrangements are made to provide additional security, could also be reviewed on a case-by-case basis. Secondly, countries that review provisioning standards only after a lengthy period, could be encouraged to make more frequent assessments, which would allow a closer tracking of a country's debt service and policy implementation record. Thirdly, more weight might be given to the great divergence in macroeconomic and structural policies across countries in varying provisioning requirements across individual cases, rather than applying a general requirement to an entire group.

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[9] *Cf.* IMF (1991a, p. 42).

(b) ***Determination of appropriate risk weights for computing banks' adherence to regulatory capital adequacy requirements***. Several middle-income countries have maintained full debt servicing throughout the 1980s - for example, Algeria, Botswana, China, Colombia, Hungary, India, Indonesia, Malaysia, Pakistan, Republic of Korea, Thailand, Tunisia, Turkey, and Zimbabwe. However, their good repayment record has not been adequately recognized in the bank capital adequacy guidelines of the Bank for International Settlements, where claims on all developing countries outside of the OECD are treated uniformly. That is, under the Basle Accord, loans to developing countries members of the OECD or lenders under the General Arrangements to Borrow carry a 100 per cent risk factor in the determination of the capital asset ratio; other sovereign loans carry a zero risk factor. This regulatory requirement discourages bank lending to developing countries, particularly if banks are capital-constrained or the spread on loans does not offset the cost of raising the incremental capital required. This would need to be adjusted in a timely fashion to reflect sustained improvements in developing countries' debt-servicing capacity.

(c) ***Flexibility in the use of cut-off credit rating standards and other regulatory restrictions for mobilizing funds on industrialized country securities markets***. Pension and insurance funds are a potential important source of long-term capital for emerging market countries. But regulatory considerations have greatly influenced the investment activities of institutional investors. Thus, an easing of restrictions on pension and insurance funds' asset composition - particularly in Germany and in the United States of America, where restrictive state laws prevail on public pension funds - would tend to increase these institutions' investments in foreign securities, including those of developing countries. An easing of restrictions would build on recent regulatory changes in industrialized countries that have facilitated developing country access to international bond markets. Thus, in June 1991 the Japanese authorities took steps to ease the credit rating standards for public placement of bonds in the Samurai market. In the United States, regulatory changes were implemented in 1990 to reduce the transaction costs and liquidity problems facing developing country issues in United States capital markets. In June 1991, the American Securities and Exchange Commission issued proposals that would exempt foreign companies from certain disclosure and accounting regulations provided that these companies met equivalent regulations in their home countries. In Canada, the Ontario Securities Commission has already adopted such a measure with respect to Mexican companies. Finally, the minimum rating requirements for foreign bond issues in the Swiss market were abolished in January 1991.[10]

C. *International financial institutions' policies*

The recommendations of the international financial institutions for new actions designed to further capital flows to developing countries comprise the establishment of a developing country currency convertibility facility jointly sponsored by the International Monetary Fund and the Bank for International Settlements as well as a multilateral new debt enhancement facility, measures designed to improve risk assessment of developing countries by international capital market participants, and technical assistance to developing countries in financial engineering and domestic financial market reforms.

1. IMF/BIS convertibility guarantee

Lack of currency convertibility is a major deterrent of capital inflows to developing countries. It is however very risky for these countries to sponsor a convertibility programme of their own, for in this case experience indicates that only very short term and easily reversible capital flows can be attracted. For this reason, Fukao (1992, p. 114) proposed that the International Monetary Fund support the maintenance of convertibility of developing countries' currencies more vigorously. One possible procedure would be that the IMF provide a very generous stand-by compensatory and contingency financing facility, in return for a very tight guarantee of convertibility, similar to the establishment of a currency board. If the Bank for International Settlements (BIS) capital rule could be tied to this facility by giving a lower risk weight for countries having this agreement, bank loans could be encouraged besides other flows.

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[10] For more information, see IMF (1992a, p. 45).

The importance of this recommendation is dramatized by the current experience of Argentina, which is adhering to a far-reaching convertibility programme, temporarily financed by the foreign exchange proceedings of massive privatizations. Faced with a disturbing currency overvaluation, Argentina is now being advised by foreign experts to generate a massive fiscal retrenchment to force domestic prices and wages down. If, instead, the Argentine Government had access to Fukao's "very generous" convertibility facility, it could attempt resolving the overvaluation problem through non-deflationary means (either through a credible one-shot devaluation or a Mexican-type crawling peg).

2. *Debt enhancement through collateralization*

In the case of Mexico, part of the strategy for re-entry into international financial markets was its acceptance that enhancement of debt instruments by the public sector may be required in the initial stages of the re-entry process. Enhancements such as collaterals, put options, and equity conversion rights were used as means to improve the marketability of debt instruments and to reduce risk premiums through overcoming extreme initial perceptions of counterparty credit and transfer risks. Szymczak (1992, p. 70) estimates that the use of collateralization techniques by Mexico has lowered borrowing costs by between 100 to 200 basis points.

Other countries with sufficiently attractive natural resources, well-developed export sectors, or large domestic markets may be able to develop these financial enhancements by themselves (even in this case, technical advice from the multilateral institutions would be welcome). Many developing economies would need more direct financial support from the multilateral institutions, which, with their participation in the Brady Plan deals, should by now have overcome their long-standing aversion to the provision of guarantees and other debt-enhancement facilities.

Such internationally based provision of guarantees should obviously not be used indiscriminately or for an unduly long period. If so, they might impair rather than improve a country's ability to borrow on an unsecured basis over the medium term. It is for this reason that Mexican public sector borrowers have reduced the frequency of collateralized borrowing, using it in only two instances in 1991.[11]

3. *Improved international risk assessment of developing countries*

To sustain spontaneous capital flows to developing countries, it will be important to broaden the investor base for the securities of re-entrant countries, both in terms of type of investor and geographical location. A narrow base raises the possibility that investor portfolios may become saturated, a development already reported in certain segments of the market. Moreover, a narrow base implies excessive sensitivity to events affecting particular groups of investors, such as, for example, movements in United States interest rates.

The most effective means of broadening investor participation is to reduce associated risk, both by decreasing underlying uncertainties and ensuring increased provision of information. In this context, the international financial institutions (IFIs) which have close contact with the countries concerned could study along with the interested developing country Governments the means by which they could make information on the latters' economies more regularly available to potential investors in industrialized countries.

Additionally, the IFIs could extend special credit lines to help the developing countries to pay for the services of bond rating agencies, on the understanding that, independently of the rating obtained, this would provide greater certainty and assurance to potential investors, and thus could increase the net proceeds of the country at the time of issue.[12]

4. *Technical assistance in financial engineering and domestic financial market reform*

Financial engineering. One characteristic of modern international financial markets is the extreme complexity of instruments and operations, as well as the apparently unlimited supply of resources available to countries (e.g. Chile) fortunate enough to stand in the grace of international finance. Chile's Finance Minister Alejandro Foxley (in Aspe *et al.*, 1992, p. 20) points to the need for international organizations to offer technical assistance in financial engineering so that countries will not be amauterish players in the truly sophisticated world capital market. This would be an important job for the World Bank, a point which Foxley has already brought to the attention of the Development Committee. Of particular importance would be technical advice on financial engineering designed to reduce the developing countries' vulnerability to external shocks. This protection could be achieved by the use of hedging techniques to offset external interest rate or commodity price fluctuations.

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[11] See Szymczak (1992) for details.

[12] On the real function of bond rating agencies in international bond markets, see Wakeman (1984).

Domestic financial market reform. According to Collyns *et al.* (1992, p. 32), domestic market reforms contributing to the gradual restoration of access to voluntary financing for developing countries have included: (a) stock market reforms and associated regulatory changes; (b) increased opportunities for investors through privatization; (c) banking sector reforms affecting the level and structure of interest rates and the allocation of credit among sectors or types of borrowers; and (d) tax policy changes to encourage the use of equity financing by commercial enterprises.

Much information and experience is available in the IFIs concerning financial market reforms, particularly after the learning process that they themselves went through, first with the disastrous financial deregulation and opening processes in the Southern Cone of Latin America in the late 1970s, and more recently with the dramatic experience with the ongoing restructuring of the financial sectors in the transforming economies of Eastern Europe and the former Soviet Union.[13] This experience could profitably be passed on to the developing countries still struggling to reform their domestic financial sectors, as required for a mutually profitable involvement with private international capital flows.[14]

D. The majority case of the developing countries without market access

Avramovic, among other participants in the 1992 FONDAD The Hague seminar on the international monetary system (in Teunissen, 1992, p. 58), has pointed out that "there are 120 indebted countries who still can't borrow". The external financing problem of these countries needs to be addressed, bearing in mind that they are not part of globalization of the monetary system or of the international financial markets formed in the 1980s and 1990s.

1. Special treatment for small countries

Latin America's re-entry into international securities markets has been the almost exclusive prerogative of large, well-known, creditworthy companies in the large countries of the region. Smaller companies in the large countries may gain indirect access to international funds through the intermediation provided by the large well connected banks of these countries. Small countries in the region, with fewer and less well known companies and banks, do not seem to able to attract in large scale the type of new private inflows now reaching the large countries. Hence, Griffith-Jones and Culpeper (1992) have underlined the importance for smaller countries to:

(a) get strong support from the IFIs in reaching soon a favourable debt settlement with foreign commercial banks, as the banks have little incentive to incur the administrative costs of regularizing these countries' debts, for which they are heavily provisioned, discounts are high, and exposure is relatively small;

(b) continue to have significant access to official capital flows; and

(c) benefit from special efforts by IFIs and industrialized governments, perhaps through guarantee mechanisms, to encourage new private flows to them.

2. The case of the low income countries

One lesson of the international debt crisis was that external finance for investment in low income countries cannot come from private banks, the lending functions of which need to be limited mostly to trade and project financing. Long term finance to low income countries must come largely from official concessional sources, for many of these low income countries are structurally weak and cannot count on attracting private capital for their development needs.

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[13] On the lessons from the Southern Cone, see Diaz-Alejandro (1985); and from Eastern Europe, see Dooley and Isard (1991). This experience could profitably be passed on to developing countries that are still struggling to reform their domestic financial sectors, as required for a mutually profitable involvement with private international capital flows.

[14] On the need for domestic financial reform prior to external financial opening, see Fischer and Reisen (1992).

Moreover, for some of the most severely indebted low income countries, the debt to export ratios remain unsustainable, even after the application of Trinidad terms and assuming all their bilateral concessional ODA loans are forgiven. Thus, restoration of their external viability will require additional action by official and commercial creditors. Included in this group are a few countries, such as Mozambique, Somalia, and Sudan, whose problems go well beyond debt, but who certainly cannot serve their debts.

II. Conclusions

In spite of the marked improvement in access to international finance for some developing countries in the past few years, their outlook in this respect is still precarious. The decline in United States and international interest rates has been critically important in the new wave of private financing reaching middle income countries. Some countries, now deluged with foreign savings, such as Chile, had been unable to attract such investment before, even though they had healthy economies. The drastic resurgence of private flows may lead to an over-estimation of the degree to which successful severely indebted middle income countries have regained sustained market access. In fact, Latin American history is full of episodes where lack of credibility and a short-term financial bubble have been associated with large inflows of "hot money" from abroad. Moreover, portfolio debt flows, especially short-term deposits, are more volatile than long term commercial banks loans and trade financing. Likewise, portfolio equity flows in emerging markets can be taken out fast at low costs. The risk of such a reversal is heightened by the volatility of international interest rates.

Action by the international community seems badly needed, particularly now that under a new administration the United States appears to be headed for an economic recovery which should improve domestic investment prospects and increase short-term interest rates, thus tending to attract developing countries' "flight capital" back to their off-shore bases.

Recommendations for international action designed to strengthen and sustain international capital flows to developing countries covered four areas: the multilateral decision-making process, the industrialized countries, international financial institutions, and the problems of the majority of developing countries which lack access to private capital markets.

Multilateral decision-making. The Group of Seven is the centerpiece of multilateral economic policy making. It is time that a developing country delegate be permanently included in its deliberations. Foreign direct investment is one of the most interesting forms of external private financing for developing countries: the establishment of a multilateral FDI facility, official debt relief, and the opening of industrialized country markets to imports from the developing and transforming economies would significantly affect the climate for direct investment inflows to these countries. The Paris Club is a cumbersome institutional mechanism for restructuring official debt contracts; an official debt agency linked to the Bretton Woods institutions could replace it with benefits for both developing and industrialized countries. The massive amounts and high volatility of short-term capital flows sometimes pose insurmountable difficulties for economic policy-making by both industrialized and developing countries: serious consideration should be given to imposing transaction taxes on trades in short-term securities, as a possible remedy for the flows of hot money.

Industrialized country domestic policies. One means of increasing the external resources available to developing countries would be to increase the level of public sector savings in the industrialized countries. It would be important, however, to act on measures both to reduce fiscal deficits and to expand access by developing countries to the domestic financial markets in the industrialized countries. Among the regulatory changes needed to achieve this objective, would be: graduation from loan loss regulatory provisioning regimes; determination of appropriate risk-weights for computing banks' adherence to regulatory capital adequacy requirements; and flexibility in the use of cut-off credit rating standards and other regulatory restrictions for mobilizing funds on industrialized country securities markets.

International financial institutions. Recommendations for actions by IFIs include establishment of a currency convertibility facility jointly sponsored by the IMF and BIS; a facility to provide new debt enhancement through collateralization and other financial techniques; measures to improve the quality of developing countries' risk assessment by international financial markets; and technical assistance to developing countries on financial engineering and domestic financial market reform.

Small and low income countries. Most developing countries, either because they are too small or too poor or both, cannot realistically expect to benefit from long-term private capital inflows. The external financing problem of these countries includes a major debt overhang. Remedies depend on substantially increased official flows.

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GUIDELINES ON THE TREATMENT OF FOREIGN DIRECT INVESTMENT

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Executive Summary

At its Spring 1991 meeting, the Development Committee of the World Bank and the International Monetary Fund requested a report on "an overall legal framework which would embody the essential legal principles so as to promote FDI (foreign direct investment)". This paper is a commentary on the Guidelines produced in response to that request by a task force consisting of the General Counsel respectively of the World Bank (as Chairman), of the International Finance Corporation (IFC) and of the Multilateral Guarantee Agency (MIGA).

The task force appears to have asked itself: in so far as the law of a country deals specifically with foreign investment as a discrete category, are there some recognized standards to determine what the law should say and what it should not say? While such an approach avoids controversy, it results in little more than a reworking of the very familiar ground covered by existing bilateral investment protection treaties. Admission, treatment, expropriation and dispute settlement are there, and so are most of the subcategories such as national treatment, foreign exchange transfers, valuation of appropriated assets and international arbitration.

It is assumed that host Governments desire inward foreign investment and that inward investors will comply completely and in good faith with all local legal requirements. Nothing more is said about the appropriate conduct of foreign investors. Nor do the Guidelines involve themselves in such issues as preservation of national culture (including the pattern of consumer tastes), the desirability or otherwise of free labour mobility, the distribution of domestic income, or the appropriate dividing line between the public and private sector.

In so far as the Guidelines manifest a general approach to FDI, that approach is described as "the liberal approach", "the general approach of free admission", and "the restricted list approach". Implicit is that the ordinary run of inward foreign investments will require no specific approvals from the host State, becoming "a largely automatic process" and confining exclusions or the need for approval to specific types of investment ("the restricted list"). Lest this loophole be opened too wide, the report emphasizes that "such limited restrictions may be inevitable"; it does not suggest these as a rule but as an exception. In line with much modern advice, the Guidelines are against offering any fiscal concessions to foreign investors that are not also made available to domestic investors. They are also against developing country Governments competing against each other in the concessions that they offer. That is an easy and honourable position to take, but it begs the important and controversial question as to how much importance foreign investors do in fact attach to concessions offered by a country in making their location decisions.

The contents of the Guidelines are summarized and assessed in sections I and II below. They are found to be a small and rather timorous contribution to a large and difficult subject. Where potentially disruptive issues are considered, the Guidelines are evasive or non-committal. With one or two exceptions there is nothing in the Guidelines which any developing country looking for foreign investment could find controversial. The commentary explicitly poses the question of whether the substance of the Guidelines and their publication constitute any sort of new threat or potential source of disadvantage to the prospects or interests of developing countries. It is this author's opinion that they are not likely to lead to the imposition upon host States of additional burdens or conditionalities beyond those that would have been required by most major foreign direct investors in any case. However, the Guidelines do criticize the attempts by host States to impose conditions or to introduce performance criteria for FDI, a criticism far too sweeping and likely to be ignored in practice by many host States. The implication that the Guidelines should apply to existing investments as well as to new investments is also likely to be generally resisted.

More pointed criticism of the Guidelines concerns not so much what they contain as what they omit. They are silent on some of the really difficult issues which now dominate discussions between Governments and foreign investors. There are four principal issues. The first is fiscal stability, and whether major investors are justified in demanding fiscal stability (or compensating mechanisms in the event of disadvantageous changes) over some major part of the life of their projects. Furthermore, if so, should similar concessions be accorded to domestic investors? The second issue concerns the most appropriate way to handle the environmental impact of major mining, petroleum and other projects. The

third point concerns the requirement of investors in projects with export potential that they keep some of the proceeds of their export sales off-shore rather than being required to remit them to the host State's Central Bank where, in countries with a history of foreign exchange shortage, they are likely to have to compete with other creditors including the International Monetary Fund and the World Bank. The fourth issue concerns the reluctance of even large transnational companies to issue parent company guarantees in the event of one of their operating subsidiaries being held liable in damages for an environmental catastrophe. These are all issues of pressing urgency, particularly for some Governments unused to dealing with major foreign investments. The silence of the Guidelines is both surprising and disappointing.

Another difficulty found with the Guidelines is that they give rise to - and already there is evidence of - a false expectation that by adopting what is described as "prevailing best practice" in the matter of bilateral investment treaties and foreign investment codes, a host State would have done all that could reasonably be expected, indeed all that would be necessary, to attract FDI. That is unfortunately very far from being the case. Hence the commentary treats a broad selection of other measures - policy, legal and attitudinal - of equal concern to any potential foreign investor as the four issues (admission, treatment, expropriation and dispute settlement) discussed in their rather narrow legal context in the Guidelines.

Other criticism of the Guidelines concerns their failure to address the valid concerns of Governments as to how legislation can deal with the potential disadvantages of TNC investments, and how Governments might promote and nurture the growth of their own private sector enterprises, sometimes within the context of regional cooperation. Will publication of the Guidelines draw attention away from actions and policies that the Development Committee should be urging upon OECD Governments for giving a far greater impetus to an increase in beneficial FDI in developing countries than the publication of these Guidelines? Such policies would include action upon the external debt overhang of some countries, upon interest rates, upon increased protectionism in the form of non-tariff barriers, upon the dumping of farm surpluses grown under subsidized price regimes, as well as other practices that have the effect of lowering the price of developing country commodity exports.

Introduction

At its spring 1991 meeting, the Development Committee of the World Bank and the International Monetary Fund (IMF) requested a report on "an overall legal framework which would embody the essential legal principles so as to promote FDI (foreign direct investment)". Preparation of this report was entrusted by the President of the World Bank to a task force consisting of the General Counsel respectively of the World Bank (as chairman), the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

In fulfilment of the request, the task force published 'A Survey of Existing Instruments' constituting the 'Legal Framework for the Treatment of Foreign Investment', which sought to identify general trends in the prevailing use of these instruments. A second document was then prepared comprising a report to the Development Committee which incorporated a set of "Proposed Guidelines". This document builds upon the trends identified in the first document but also purports to take into account what have been identified as "prevailing best practices" by the World Bank Group as well as the need to ensure "broad international acceptability".

What happened to the request of the Development Committee in practice is clear enough. The lawyers who took charge of the matter, for prudential reasons no doubt, interpreted their mandate in the narrowest possible way. They apparently asked themselves the following question: in so far as the law of a country deals specifically with foreign investment as a discrete category are there some recognized international standards to determine what the law should say and what it should not say? The approach avoids controversy and getting bogged down in a struggle with unfamiliar or imponderable issues. It results, however, in little more than a reworking of the very familiar ground covered by existing bilateral investment protection treaties. These treaties have proliferated in recent years and are no longer in any real sense controversial. Collectively they may be viewed as being like the Treaty of Utrecht: marking the end of a long period of conflict generated by an ideological confrontation very damaging to the protagonists.[1] Rather than breaking new ground the treaties demarcate, with varying degrees of clarity, the boundaries of an established, but limited, consensus.

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[1] For an account of the changing ideological climate for foreign investors, see "Transnational Corporations and World

A review of bilateral investment treaties[2] shows that they cover the same topics as the Guidelines and frequently embody the same or very similar conclusions. Admission, treatment, expropriation and dispute settlement are included invariably; so are most of the subcategories which appear in the Guidelines such as national treatment, foreign exchange transfers, valuation of expropriated assets and international arbitration. Although the Report (in paragraph 8) makes clear that the Guidelines are not intended to have binding or mandatory effect, with a few exceptions - such as section 3 on Admission where an avuncular style is adopted, they are cast in a grammatical form appropriate for a treaty, contract or statutory enactment. Given that approach, it would have been more straightforward, and certainly of more practical use to most developing countries, if the lawyers had responded to the Development Committee with the publication of a model investment protection treaty, annotated in a commentary clause-by-clause fashion. Such a commodity emanating from the Bank, the Fund and MIGA would have had, within its limited scope, real value.

Given that the framework for the Guidelines was broadly based on the subject matter of investment protection treaties, could they have been imbued with more contemporary relevance? At the risk of some controversy, could they have broken new ground by dealing directly with some of the really thorny issues which now dominate discussions between Governments and foreign investors? The author believes that this could have been done. Later in this paper an indication is given of some of the issues and topics which could have been usefully covered.

Despite the disappointing timidity of the Guidelines, their potential influence should be obvious. At a time when so many developing countries are declaring their intention to give a more prominent role to private sector activities - and the role of FDI in private sector modernization and growth is also being strongly urged - Guidelines promulgated by the Development Committee are very likely to become tantamount to required standard practice. At the very least they are likely to be universally quoted as the prime reference point of what constitutes good governance in this area of the State's activity.

In this context, does the substance of the Guidelines pose any new threat or potential source of disadvantage to the prospects or interests of developing countries? It is this author's opinion that the Guidelines in themselves do not. Specifically, publication of the Guidelines and their endorsement by the Development Committee are not in themselves likely to impose additional burdens or conditionalities upon host-country Governments in the form of actions or concessions beyond those that would in any case have been required by most major foreign direct investors. They do, however, criticize host States' attempts to impose conditions on inward investment (such as an insistence on joint ventures) or to introduce performance criteria; in practice, many host States will likely reject such assumptions.

There are, however, certain dangers and difficulties inherent in the Guidelines. First, the Guidelines may arouse false expectations among Governments not used to dealing with foreign private investors. Secondly, the Guidelines fail to address the valid concerns of Governments as to how legislation could deal with the potential disadvantages of TNC investments, and how Governments might also promote and nurture the growth of their own private sector enterprises, sometimes within the context of regional cooperation. Thirdly, they may draw attention away from actions and policies that the Development Committee could urge upon OECD Governments so as to give far greater impetus to increased FDI in developing countries. Fourthly, their manifest asymmetry of influence is revealed clearly in the fact that agreement on Guidelines for the conduct of developing country Governments could be reached in the Development Committee in less than two years while attempts to reach agreement in the United Nations on a Code of Conduct for Transnationals has had to be abandoned after more than ten years of effort.

These observations will be expanded upon in later sections. More immediately in section I a summary description is given of the contents of the Guidelines. Section II assesses those contents on strictly legal grounds. Section III draws attention to four difficult issues on which the Guidelines offer no guidance. Section IV considers the role of foreign investment codes. Section V lists a set of other matters, hardly touched upon by the Guidelines, which will weigh with any potential foreign investor. Section VI attempts to look at the whole issue of encouraging FDI in a wider

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Development", Chapter XIX, "Relations between host developing countries and transnational corporations", p. 313, United Nations Centre on Transnational Corporations, 1988.

[2] United Nations Centre on Transnational Corporations, *Bilateral Investment Treaties*, New York, 1988.

context. Finally, section VII deals with other actions which the international community might take with the prospect of doing more to promote the beneficial flow of investments to the less developed economies than the publication of these Guidelines.

I. The Guidelines

The Guidelines are professedly legal in character. They attempt to do no more than set out a framework of principles that the individual host State may then embody in its own laws, agreements, treaties, regulations, etc. They do not, for instance, cover issues relating to the preservation of national culture (including the pattern of consumer tastes), immigration, the distribution of domestic income, or the appropriate dividing line between the public and private sector. It is assumed that host Governments desire inward foreign investment and that inward investors will comply completely and in good faith with all local legal requirements. Nothing more is said regarding the appropriate conduct of foreign investors in the host State, on the grounds that a set of rules for this purpose has already been reflected in negotiated provisions of the draft Code of Conduct of the United Nations Centre on Transnational Corporations (UNCTC).

The main areas covered are (a) the admission of foreign investment; (b) the treatment of foreign investment, particularly in respect of the transfer of capital and returns; (c) expropriation and unilateral alterations or termination of contracts; and (d) the settlement of disputes. In the following sections the proposed Guidelines are summarized under these four headings.

A. Admission of foreign investment

Each State is expected to encourage and facilitate investment in its territory of capital, technology and managerial skills by nationals of other States, whether corporate or individual. While procedures, regulations and conditions may be set by the host State governing FDI, these should not be unduly cumbersome or complicated. Experience suggests (say the Guidelines) that performance criteria such as minimum local ownership, local employment or export targets, although perceived to be in the national interest, are often counterproductive in that they either discourage foreign investors or give rise to evasion and corruption. Unrestricted admission, save for certain listed investments which would either be prohibited or would need screening and licensing, is advocated as a more effective approach. Nevertheless, a State may reserve certain investments for its own nationals or may refuse a proposed investment deemed to be contrary to the interests of national security, public health or public order, protection of the environment, or simply unconducive to its economic development. Each State is encouraged to publish and publicize regularly updated information regarding its legislation, regulations and procedures affecting FDI, including an indication of those classes of investment which are prohibited, subject to screening and licensing, or reserved for nationals.

B. Treatment of private foreign investment

The first fundamental principle proposed is that, in respect of the legal protection of their person, their property (including intellectual property) and their rights and in the grant of permits, licences, authorizations, visas, etc., the treatment of foreign investors should not be less favourable than that accorded by the State to national investors. In a similar vein, the host State should not discriminate among foreign investors on grounds of nationality. The second fundamental principle is that the State should not refrain from doing everything necessary within its own competence for the efficient and uninterrupted operation of the approved investment. This action extends to the prompt issuance of licenses and permits, and authorization for the employment of foreign personnel - although the State may reasonably require the investor to establish his inability to recruit locally before resorting to recruiting abroad.

With regard to the transfer of funds abroad, the host State should freely allow transfer of the net revenues realized from the investment (subject to the exceptions authorized under the Articles of Agreement of the IMF or in relevant treaties) and of such sums as may be necessary to discharge all due obligations, including the servicing and repayment of contracted debts. On liquidation or sale of the investment, the investor should be allowed to repatriate the proceeds immediately or, where the State faces foreign exchange stringencies, over a period not exceeding five years with interest at the normal commercial rate accruing upon retained funds until such time as the transfer is actually effected. Foreign personnel employed should be allowed to transfer regularly a reasonable part of their salaries and wages and, upon termination of their employment, should be allowed an immediate transfer of all savings from such salaries and wages. The Guidelines make it clear that the transfers provided for should be made at the market rate of exchange prevailing at the time of the transfer.

Consistent with much modern advice, the Guidelines do not suggest that a host State should provide foreign investors with tax exemptions or other fiscal incentives. Reasonable and stable tax rates are considered to provide a better incentive. Competition among host States in providing tax exemptions is particularly deplored. Again, in line with most modern thinking, where incentives are deemed to be justified, the advice is that they should preferably be granted automatically, linked to the type of activity which the State particularly seeks to encourage. Moreover they should be available equally to national investors in similar circumstances. As almost an afterthought, the Guidelines commend fiscal incentives that are provided by the investors' own Government (presumably an OECD country) for the purpose of encouraging investment in developing countries.

C. Expropriation and unilateral alterations or termination of contracts

The Guidelines say that a host State may not expropriate or nationalize in whole or in part a foreign private investment, or take measures which have a similar effect, except where this is, in good faith pursuant to a public purpose, done in accordance with applicable legal procedures without discrimination on the basis of nationality and against the payment of appropriate compensation. A discussion follows below of what principles should be applied to determine that such compensation is "appropriate".

Compensation will generally be considered appropriate if it is based on a fair market value of the asset taken, paid without undue delay. But how is "fair market value" to be determined in the absence of an actual agreed sale between a willing buyer and a willing seller? The Guidelines suggest three different criteria. For a going concern with established profitability, fair value may be based on a discounted net cash flow calculation taking account of risk, the expected rate of inflation and the time value of money. The rate of return available in the same market on investments of a comparable character may also be a guide. For an enterprise which has not been profitable, liquidation value (i.e. the realizable value of the assets minus unavoidable liabilities) may be used. For other nationalized assets - those which are neither steadily profitable nor consistent losers - fair market value may be estimated on the basis of the replacement cost of the assets taken or, if a market valuation has recently been written into the accounts, on the basis of book value.

Compensation should also be effective, in the sense of being paid in a currency of use to the investor, and paid either promptly or, if the State faces foreign exchange difficulties, in instalments over a period not exceeding five years with market-related interest in the currency of compensation applied to all deferred payments.

Where comprehensive, non-discriminatory nationalizations are embarked upon under circumstances of war, revolution or similar exigencies, the Guidelines suggest that compensation may be more appropriately determined by Government-to-Government negotiations (between the host State and the investors' home States) rather than through negotiations with individual companies. Should Government-to-Government negotiations fail, international arbitration is proposed.

II. An assessment

What are we to make of these Guidelines emanating from some of the world's most powerful and influential institutions? They are a small and rather timorous contribution to a large and difficult subject. Based on a review of existing bilateral investment treaties and investment codes, they do not go beyond the four basic categories usually covered by the treaties and codes - admission, treatment, expropriation and dispute settlement.

With one exception, or apparent exception, there is absolutely nothing in the Guidelines which any developing country looking for foreign investment could find in the least bit controversial. Where potentially disruptive issues are considered, the Guidelines are evasive or non-committal. For example, on the subject of international arbitration, which continues to be unacceptable to Latin American countries committed to the jurisprudence of the Calvo Clause, the Guidelines play safe, and make no substantive recommendation of any kind. Guideline V.1, in a purely descriptive statement without normative content, says:

> Disputes between private foreign investors and the host State will normally be settled through negotiations between them and failing this, through national courts or through other agreed mechanisms including conciliation and binding independent arbitration.

If we exclude resort to violence, that description seems to cover all the possibilities and is stated in a quite neutral way with no indication of any preference. The only advice offered in this part of the Guidelines is in Guideline V.3. Where agreement has been reached on independent arbitration, in a gentle puff for the in-house product, the International Centre for Settlement of Investment Disputes (ICSID) is recommended. That will not upset any developing countries but might be regarded by the International Chamber of Commerce in Paris as unfair competition.

Another example is compensation for expropriated assets. The subject often proves controversial and the Bank Group might have been expected to take a clear and decisive line. In fact the Guidelines seek to take account of different and sometimes contradictory opinions. The result could not be called controversial but leaves an unmistakable impression of intellectual disorder. Guideline IV.1 establishes that there must be payment of "appropriate" compensation. "Appropriate" is the word used in the now famous General Assembly resolution 1803 of 1962 on permanent sovereignty over natural resources. However, the Guidelines go on to support the United States State Department position by equating "appropriate" with the Cordell Hull formula - "Compensation for a specific investment taken by the State will, according to the details provided below be deemed appropriate if it is adequate, effective and prompt". That formulation may be reassuring to the capital exporting countries but it does not eliminate ambiguity. It avoids saying that compensation will not be appropriate unless it is adequate, effective and prompt. A margin for a different standard has quite deliberately been left open, no doubt to accommodate the contingency referred to in Guideline IV.10 (see below).

Repeating the same grammatical form, Guideline III says in another apparently orthodox stipulation "Compensation will be deemed adequate if it is based on the fair market value of the taken asset as such value is determined immediately before the time at which the taking occurred or the decision to take the asset became publicly known". Again there is a margin left open for the application of a different test, and a different approach, if not a different test, is foreshadowed in Guideline V. This affirms that fair market value will be acceptable if determined by the State according to reasonable criteria related to the market value of the investment. That means an amount that a willing buyer would normally pay a willing seller after taking into account various factors. One of the factors that the Guidelines say should be taken into account is "the circumstances in which (the investment) would operate in the future". While that sounds quite reasonable, it would permit a Government assessing the value of an expropriated asset to advance destructive hypotheses about the future which could have a very adverse effect on the value of an asset.

Assumptions about the future figure as one of the conceptual problems in the valuation of expropriated assets. Where, as recommended by the Guidelines in the case of a going concern, valuation is on the basis of discounted cash flow value the problem is obvious. This may well be the reason why the Guidelines make a special case for "comprehensive non-discriminatory nationalizations effected in the process of large scale social reforms under exceptional circumstances of revolution, war and similar experiences" (Guideline IV.10). In the face of such events, the continuity of expectations is broken and there is really no way to calculate the value of an asset on the basis of a discounted cash flow. Although Guideline IV.10 makes sense in that context, difficulties in knowing when it would apply must create havoc with the simplicities of the Hull formula. The remote origin of this provision is probably a footnote of the late Sir Hirsch Lauterpacht in the 5th edition of Oppenheim, *International Law*. Referring to cases in which fundamental changes in the political system and economic structure of the State or far-reaching social reforms entail interference on a large scale with private property, he wrote: "In such cases, neither the principle of absolute respect for alien private property nor rigid equality with the dispossessed nationals offers a satisfactory solution to the difficulty. It is probable that, consistent with legal principles, such a solution must be sought in the granting of partial compensation." The Guidelines do not follow Lauterpacht in recommending the payment of partial compensation. No standard is proposed. However, where the Guidelines apply it is suggested that compensation should be determined through negotiations between the host State and the investors' home State or, failing that, through international arbitration. In a striking example of evasiveness, no criteria for the arbitration are proposed.

In one respect the Guidelines could be said to raise a question which may generate some controversy among developing countries. This concerns admission. Section 3 of the Guidelines starts by noting that each State maintains the right to make regulations to govern the admission of private foreign investments. It then goes on to say that experience suggests that certain performance guarantees introduced as a condition of admission are counter-productive and that open admission, possibly subject to a restricted list of investments (which are either prohibited or require screening and licensing), is a more effective approach. These statements constitute advice on a question of policy, acceptable to some countries but likely to be rejected by others. They seem quite out of place in a text purporting to be an overall legal framework "embodying essential legal principles". The drafters seem to have recognized this as in this particular Guideline they have adopted an avuncular style which avoids the grammar used to make normative statements in statutes, treaties or contracts. However, in that respect consistency is not maintained. The subsequent Guideline in section 4 dealing with the same subject treats section 3 as though it had established a rule and goes on in language more appropriate to a statute to say: "a State may as an exception refuse admission to a proposed investment

(i) which is, in the considered opinion of the State, inconsistent with clearly defined requirements of national security; and

(ii) which belongs to sectors reserved by the law of the State to its nationals on account of the State's economic development objectives or the strict exigencies of its national interest."

This haphazard drafting is bound to cause confusion and may even seem provocative to some developing countries. If section 3 of Guideline II is intended, like the rest of the Guidelines, to establish a norm, greater precision would be needed. For example, some rather obvious distinctions need to be made about performance criteria. In natural resource projects - mining, petroleum, forestry and fishing - where access is given to resources through some form of licensing, performance criteria invariably cover work and, usually, expenditure obligations and a whole range of other important matters.

III. Four difficult issues

As an illustration of where the Guidelines could have been of more direct assistance, let us consider some of the really difficult issues which currently dominate most negotiations of major projects between Governments and potential investors in developing countries. The issues selected are of particular importance in respect of major natural resource projects being negotiated by Governments in the process of moving away from systems of extensive state ownership and rigid central planning. The projects involve long-term contracts and commitments for capital expenditure which, in some cases, may amount to billions of dollars. Some of the countries concerned have no track record of fair dealing with foreign investors; so mining and oil companies have to ask themselves what guarantees they should be seeking. Likewise, many Governments, unfamiliar with the way private sector companies reach decisions, want to know what they will be obliged to concede in order to attract the investments they seek. In the end, of course, a modus vivendi will be struck through negotiation. So far, it seems to be taking an unconscionably long time, and time which none of these countries can afford to waste.

In the context of reaching agreement, what help could Governments and companies derive from the Guidelines as they stand? If the lawyers who prepared the Guidelines had boldly taken the lead on some controversial issues, could they have dispelled some of the distrust and misunderstanding which now impede the flow of investment? To answer such questions, it may be helpful to consider four key issues which have to be settled in most major projects in the natural resources sector. A consideration of these elements follows.

A. *Fiscal stability*

No mining or oil company will commit itself to a major investment to explore or develop mineral resources without being satisfied that in the event of identifying a commercial deposit it could earn a rate of return commensurate with the risk assumed. That means projecting a cash flow over the life of a project. This cannot be predicted without making assumptions about royalties, taxes and other fiscal questions. Investing in a developed country with an established market economy, certain mining and oil companies may be prepared, without contractual commitments from the State, to assume some continuity in fiscal policy. In the case of most developing countries and especially for those struggling to move from command to market economies, a prudent foreign investor will always require from the State or its agencies undertakings which guarantee fiscal stability or have that effect.[3] Are investors justified in making these demands? Should Governments be told that they cannot expect large-scale investment without such undertakings? Unfortunately, the Guidelines neglect such questions entirely. In fact, this vitally important topic is simply not mentioned. The omission is surprising since the issue raised, although it affects more directly the economics of mineral-based projects, has a clear legal dimension which ought to have brought it within the ambit of the report called for by the Development Committee. If foreign investors are justified in requiring guarantees of fiscal stability, how can giving those guarantees skirt difficult constitutional issues? Mining and oil companies have shown commendable ingenuity in developing forms of contract which avoid any direct challenge to the host country's legislative competence. However, countries new to foreign investment and new to market economics often remain sceptical on this point. In fact they need authoritative guidance; a helping hand from the World Bank would be of inestimable value.

The issue of fiscal stability also gives rise to the difficult question of principle on which the Guidelines are silent. Under the heading "treatment", following the pattern of most investment protection treaties, the Guidelines establish the rule that foreign investors will be accorded treatment as favourable as that accorded to national investors. Furthermore, as regards matters "not relevant to national investors", treatment under the State's legislation and regulations will not discriminate among foreign investors on grounds of nationality. The Guidelines themselves do not specify the matters which are "not relevant to national investors", but the report (in paragraph 16) mentions in the same context "repatriation of investment capital and returns". What about fiscal stability? Foreign investors who demand contractual stipulations limiting a government's 'take' in natural resource projects can say that they do not, and often cannot, participate in the political life of the host country. Given that constraint, they cannot be expected to make huge up-front investments on the basis of an open-ended fiscal regime. In that respect the position of local investors is clearly quite different. Does it follow that guarantees of fiscal stability are, in the language of the Guidelines, "not relevant"? There could be serious constitutional/political objections to the State offering a particular category of its citizens contractual undertakings which would protect, or have the effect of protecting them, from the incidence of any future tax changes. If it is right to raise such objections, should they nevertheless be disregarded in the interest of creating competition between foreign and local investors on a level playing field? These are difficult questions to which there may not be any simple answers. The problem is not just one of economic management. The issue essentially concerns what the World Bank calls "governance". The silence of the Guidelines on this score is particularly surprising in view of the overriding importance which the World Bank now attaches to questions of governance.

B. *Environmental impact*

In natural resource projects, reaching agreement in negotiations over fiscal stability has become somewhat easier in recent years because of the development of self-adjusting mechanisms for sharing the surplus, e.g. the "R" factor in production-sharing agreements, and additional profit taxes based on a discounted cash flow rate of return.[4] In contrast, it has become much more difficult to reach agreement on an appropriate way to handle the environmental impact of mining and petroleum projects. Governments, with active encouragement from such international financial institutions as the World Bank, are increasingly aware of their responsibility for protecting the environment. Companies are generally willing in principle to do their part but, as in the case of the fiscal regime, they are reluctant to assume open-ended commitments. Companies quite naturally want first to define and then to stabilize the limits of their responsibility.[5]

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[3] Exxon, in a recent memorandum on behalf of the Petroleum Advisory Forum, said in the context of the latest draft of a Petroleum Law for the Russian Federation: "Aside from questions as to the type and amounts of taxes, any tax regime should be such that a potential investor can determine with a high degree of certainty the taxes and other Government charges which the project must bear over its life. In other words the tax regime must be stable and predictable. This means that the tax package should not be susceptible to change, should be all-inclusive and should be stated in clear and definitive terms."

[4] In the petroleum industry the R factor refers to an arrangement whereby the split of profit in a production-sharing

At the development stage of any mining or petroleum project consideration of environmental issues will always take place. However, in many - perhaps most - developing countries and in countries emerging from a condition of state monopoly, there is no existing network of statutory requirements confronting the operator. Provisions designed to prevent or limit environmental damage will be project-specific and will have a consensual dimension.

Characteristically, a mining or petroleum code or exploration and production agreement will have a provision requiring the preparation of a development plan when commerciality has been established and a company is seeking long-term rights in a lease or production licence. Normally the development plan or company 'proposals' will require approval by the Government before a lease or licence is issued.

What should happen if there is disagreement? Should the Government be prepared to go to arbitration or submit the dispute to a binding determination by a third party expert? Where the issues involve technical questions relating to the way operations should be carried on - cut-off grades, production profiles, infrastructure design and utilization - Governments in most developing countries are now prepared to agree to dispute settlement provisions involving international arbitration or expert determination. This affords considerable reassurance to prospective investors and is clearly an important element in a modern mining or petroleum code.

If the dispute preventing agreement on the development plan is about environmental management, should Governments be prepared to accept arbitration or expert determination? At the development plan stage, companies may have spent very large amounts on exploration and feasibility studies and could stand to lose these investments if a Government imposed unreasonable or arbitrary requirements inconsistent with the economics of the project.

The problem for companies is obvious, but how should Governments respond? Would it be right or, indeed, feasible politically, for Governments to allow foreigners to decide on issues which may involve for its own people balancing the advantage of increased revenue from a mining project against the disadvantage of environmental damage?

For a complete understanding of the problem, certain distinctions have to be made. If standards have, in a particular context, been established by the Government and accepted by the investor (e.g. the acceptable level of suspended particulate matter in a river system resulting from mining operations), there should be no real objection to expert determination in a dispute about whether proposals in a development plan are adequate to ensure compliance with established standards. Conversely, the situation is quite different if the dispute is about what standard should be established. In that case, the issue is how much damage to local interests should be permitted for the sake of a profitable mining project from which the Government will derive needed revenues. Fundamentally that is a political question; for Government, it is one that is constrained by the need to attract investment and develop the project in question. The resolution of such issues is what investors and Governments talk about when they negotiate major projects but the Guidelines do not refer to them.

Another difficult Government/investor issue has to do with the environment but is not confined to the case of large-scale mining and oil projects. Where a foreign investor commits substantial capital for a project on the basis of compliance with an agreed plan to deal with the environmental impact or in compliance with established statutory provisions, what happens if later there is a change in the Government's requirements? Government may wish to alter its requirements because:

(a) It may have decided over a period of time that stricter standards should apply;

(b) New scientific data may have been produced showing the existence of danger or deleterious consequences not previously known;

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agreement is determined in any year of production by the ratio of the contractor's cumulative inflows to the contractor's cumulative outflows.

[5] For a fuller treatment of these issues, see Roland Brown and Philip Daniel, "Environmental issues in mining and petroleum contracts", *IDS Bulletin*, vol. 22, No. 4, October 1991.

(c) Some unforeseen physical events or dimensions may have become apparent in the project itself.

For investors, the prospect of a Government changing the rules of the game after their investment is in place is alarming. A major mine may cost as much as a billion dollars and, however large the players, a substantial part of the capital is likely to be borrowed and secured (*inter alia*) on the project. That means that banks as well as mining and oil companies have a stake in the issue. If there is a drastic change in the rules after the investment has been made the economic assumptions on which the decision to develop was taken may be undermined. That, of course, is an old problem in terms of the fiscal regime, and one which is largely solved by the development of more flexible fiscal arrangements. In the context of environmental controls, the issue can be more intractable.

Some companies have tried to seek a special status for their approved environmental plan such that their project will be exempted from any future environmental laws or regulation, or government actions, that would alter the basis upon which the project was to be developed and operated from that envisaged in the approved development plan. Few Governments would accept such an arrangement, nor do companies realistically expect it. However, in this area a genuine problem exists with no obvious solution.

C. Foreign exchange transfer

On the issue of transfer payments the Guidelines follow a pattern established by most foreign investment protection treaties and by many of the investment codes. While guarantees may afford some comfort to foreign investors they do not satisfy a basic requirement for companies investing in major natural resource projects or making other investments based wholly, or in part, on export potential. To understand why that is so, it is necessary to look at the form the provisions take in the Guidelines. Each of the stipulations set out in Guideline III.6 says that transfers of certain kinds will be "allowed". That wording conceals the reality behind these transactions. Unless there is a complete absence of exchange control, with freedom to buy and sell foreign exchange at will, the transfers which are to be "allowed" can only take place if the Foreign Investor can trade through the Central Bank, or its agents in the Commercial banking sector, the foreign exchange required to make the payments concerned. In other words, if any substance is to be given to the undertakings set out in the Guidelines, they must be read as a guarantee by Government that foreign exchange will be made available to enable certain payments to be made in convertible foreign exchange. In some developing countries with a long history of foreign exchange shortage, it is clear that even with the best will in the world such a guarantee is one which Government may not be able to implement. Any attempt to do so could result in default across the board, including default on obligations outstanding to the World Bank and the Fund.

Mining and oil companies are aware of these realities and treat undertakings of the kind set out in the Guidelines as subject *de facto* to a concept of *force majeure*. Hence before undertaking a major investment in a developing country, they invariably require a commitment from Government to permit them to retain offshore the proceeds in foreign exchange from the sale of mine products or petroleum. That commitment is, of course, always subject to a requirement that the foreign investor will bring in foreign exchange to meet tax and other local obligations as they arise in the host country. There may also be safeguards - sometimes, as in the case of Papua New Guinea, very elaborate safeguards - but the substance of the commitment required from Government is essentially a non-negotiable issue.

D. Liability for operating subsidiaries

The increasing emphasis on environmental concerns, and the related occurrence in recent years of a number of environmental disasters, has given rise in natural resource projects to a relatively new source of controversy. The financial consequences of such events as Bophal and the Exxon Valdez can have a very damaging impact on the balance sheet of even the largest and strongest corporate players. For this reason Governments can no longer take it for granted, as they might have done 20 years ago, that a major mining or oil company will always stand behind a wholly owned subsidiary which has been held liable for damages in an environmental catastrophe. Project-specific companies, without significant assets of their own, continue, with the acquiescence of Governments, to be used in mining and petroleum investments. Increasingly, Governments see the need for parent company guarantees and increasingly companies are declining to accept open-ended commitments which could, on a worst-case assumption, run into billions of dollars. This is pre-eminently a matter for the international community and the silence of the Guidelines is again both surprising and disappointing. The authors of the Guidelines cannot assume that the issue concerns the conduct of transnational corporations and would fall under the UNCTC code of conduct even if that initiative had not been aborted. If investors do not offer parent-company guarantees, Governments will react by imposing conditions, and the issue then falls within the area which the Guidelines were intended to cover.

IV. Investment codes

Nowhere do the Guidelines themselves use the words "foreign investment code" despite their widespread use as part of the legal framework which many developing countries have created for dealing with inward direct foreign investment. However, the accompanying report to the Development Committee referred to "investment codes" or "national investment codes" (on pages 14, 17, 18, 19 and 21), and from these references and the relevant passages in the Guidelines themselves, it is possible to gain a coherent impression of what the authors believe an investment code should or should not contain.

Whether or not an investment code exists and has legal status, it is clear that the Guidelines support the publication of an "investment handbook" which will be regularly updated and which will "summarize the applicable rules, refer to all the relevant laws and regulations and provide other information that investors typically require, whether or not they are reflected in an investment code".

The approach which any such code would desirably take, for both new and existing investments, is also made clear. In different places it is variously described as "the liberal approach", "the general approach of free admission", and "the restricted list approach". In essence the ordinary run of inward foreign investments will require no specific approval from the host State (any more than they do now in most OECD countries) - admission will become "a largely automatic process" confining exclusions or approval requirements to specific types of investment (i.e. "the restricted list") judged in need of such control. Lest this loophole be opened too wide, the report emphasizes that the Guidelines recognize that "such limited restrictions may be inevitable; it does not suggest them as a rule but as an exception." However, it bears emphasizing that such foreign investments will not be exempt from the host State's ordinary laws and regulations which typically will require registration of the investment.

The type of investments that may legitimately be placed on a restricted list are (a) foreign investments which threaten national security, and (b) those which belong to sectors reserved by the law of the State to its nationals as part of the State's economic development objectives.

Other indications of what the authors of the Guidelines believe an investment code should contain (and what the accompanying administrative arrangements should consist of) almost certainly go further in the direction of liberalization than many host States will want to go, particularly in respect of existing investments. The documents "caution" against imposing particular performance requirements such as minimum local ownership, insistence on recruiting locally a certain number or proportion of personnel, or the setting of export targets. Instead they stress the advantages of "market freedom of hiring" especially of top management unrestricted by nationality, and the importance of "labour flexibility". The report further emphasizes that foreign investors should not be put at a competitive disadvantage with domestic investors in respect of access to permits and authorizations. Less controversially, the Guidelines stress the need for timely issuance of all authorizations and endorse "streamline admission procedures (where these are still necessary) through such devices as 'one-stop shops' for investment approvals."

Of most of the other components which characteristically find their way into investment codes, the Guidelines say nothing. Passages summarized in section 2 of the Guidelines, normative in character, cover: the transfer of moneys needed to service foreign obligations and to pay dividends; the need for the prompt issuance of licences and permits; and authorization of the investor to recruit abroad once he has satisfied the Government of his inability to recruit the required skills locally.

There is no direct mention of the attitude of the Guidelines towards a long list of measures which form part of the legal framework in any developing country seeking to attract foreign investors. These measures and instruments include: tariff protection, exclusive licensing, access to domestic credit, guaranteed tax rates or compensation in the civil courts if fiscal charges are increased, exemptions from (or rebate on) the importation of equipment and materials, initial investment allowances, accelerated depreciation, tax holidays, or the right to carry losses forward (or backward).

Although the Guidelines are reticent concerning such nitty-gritty elements of most investment codes, it would not be quite accurate to say that no inference can be drawn. The Guidelines are against any fiscal concessions being offered to foreign investors which are not also made available to domestic investors. The Guidelines are also against developing country Governments competing against each other in the concessions that they offer in order to attract foreign investment. That of course is an easy and honorable position to take. But it begs an important and controversial question. That question is: in making their decisions concerning investment, how much importance do investors attach to tax concessions made available by different countries?

The literature on this subject is ambiguous.[6] It is clear that many development economists do not like such incentives. "It has ... been known for some time that give-away incentives such as tax holidays are not effective in attracting [foreign direct investment] and yet are costly, particularly when developing countries compete against each other".[7] Nevertheless empirical studies are very far from showing that they are not effective and, on some occasions, necessary.

Despite the uncertainty surrounding this subject, and the understandable reticence of the Guidelines, a number of propositions about special investment incentives and foreign investment codes do seem reasonably sure:

- First, most foreign direct investment does not flow as a result of special tax incentives, and the countries most successful in attracting FDI (mostly OECD countries) do not have foreign investment codes;
- Secondly, the security of the investment, the stability of operating conditions (including fiscal conditions) and the prospect of being able to make and remit profits are more important to investors than the prospect of especially low taxes on profits realized and remitted;
- Thirdly, the promulgation of a foreign investment code is thus, in a sense, a recognition of weakness, an acknowledgement that special assurances and incentives have to be offered to compensate for a bad track record in dealing with earlier investments, to counteract unfavourable economic conditions, or to assuage investor nervousness;[8]
- Fourthly, although certain other matters are more fundamental, the promise of tax concessions does count with most foreign investors and may, at the margin, be decisive in determining whether or not an investment is made, or where it is made if alternative locations are available;
- Fifthly, it is perfectly consistent to acknowledge that the competitive offering of tax concessions to foreign investors may well be harmful to developing countries as a group while at the same time a necessary policy for any individual developing country faced with the knowledge that such concessions are being offered by potential competitors operating in the same sector or region.

V. Other matters of importance to foreign investors

The Development Committee requested a report on "an overall legal framework which would embody the essential legal principles so as to promote foreign direct investment." The three General Counsels chose to interpret this request as if all they had to report on were those legal principles which applied only to foreign investment, and so avoid devoting any attention to policies and legal principles necessary to promote all investment, whether foreign or domestic. This act of self-restraint certainly made the task more manageable. The result may indeed be a source of relief to those members of the Group of 24 who were apprehensive that a Development Committee report on FDI might become a font of new conditionalities to be introduced into future adjustment programmes. The effect is nevertheless curious - rather like a doctor prescribing treatment only for a leg when clearly the reason why the patient has difficulty in walking is because of weakness in his entire physionomy.

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[6] See S. Guisinger, "Rhetoric and reality in international business: a note on the effectiveness of incentives" in *Transnational Corporations*, vol. 1, No. 2, 1992 (August), pp. 111-123.

[7] H. Hughes and G. Dorrance, "Foreign investment in Asia" in Vincent Cable and Bishnodat Persaud (eds.), *Developing with Foreign Investment*, London: Croom Helm, pp. 44-66 (quoted in Guisinger, *ibid.*).

[8] Of 48 foreign investment codes looked at by the task force, over half (26) were for African States.

This has given rise to some disappointment and frustration among certain developing country Governments. We mentioned earlier our concern that, having interpreted "prevailing best practice" in the matter of bilateral investment treaties and foreign investment codes, the Guidelines might convey the impression that, in adopting these, a host country Government would have done all that could reasonably be expected, indeed all that would be necessary, to attract foreign direct investment. The reaction of some Governments which, after having implemented generous investment codes, found that substantial flows of inward direct investment still did not follow, lends credence to this apprehension.

That being the case, it may be useful to list, albeit in very summary form, the more general underlying conditions. Some of them involve a legal framework while others touch upon broader policy issues which are crucial in the mind of a potential investor. Any such list would include:

(a) An appropriate legal framework for business. This implies a companies act, a law of contract, a law of bankruptcy and evidence that local courts do not discriminate against foreigners. It also implies acceptance of normal accountancy conventions.

(b) How the domestic private sector is treated. The welcome extended to the foreign investor will be insincere if the domestic private sector is repressed and discriminated against.

(c) The country's track record in dealing with earlier investors. Just as a good track record lowers the supply price of capital, in terms of the rate of return sought on risk, so a poor track record inevitably raises the price, however strong the protestations of reform from the current Government.

(d) Exchange rate policy. An over-valued exchange rate will be regarded as a form of additional tax by any investor producing for export, while those producing for the domestic market will suspect that the resulting shortages will mean that imported materials will be difficult to obtain and dividends even more difficult to remit. Subsequent devaluations, however, may well result in large capital losses for the foreign investor if the equity element in the investment is denominated in local currency.

(e) Management of inflation. Rapid inflation adds to costs and is usually evidence of a Government's inability to match its own revenues with expenditures. It may have the technical effect of devaluing the capital allowances of businesses, artificially increasing their profits, and thus indirectly increasing the real rate of taxation.

(f) Adequate infrastructure to support productive enterprises. Few factors can so severely disrupt production, make it difficult to meet delivery commitments, raise costs and cut into profits as can frequent and unanticipated disruptions in the delivery of the power supply. Similarly the reliability and cost of rail and harbour facilities, water supply, local transportation for the workforce and, in particular, telecommunications are vital factors.

(g) The quality of the labour force and labour regulations. Productivity is perceived to depend not only on the industriousness and adaptability of local workers but also upon the reputation of the local trade unions. Labour ordinances act as a deterrent when they effectively give the Government the power to determine who should be employed, upon what terms and with dismissals subject to government approval.

(h) Price controls. Too wide a power to impose price controls gives the Government, rather than the market, the power to determine an enterprise's profitability or losses. Where price controls are recognized as being necessary, the investor will look for a formula that is applied automatically, rather than be put in the position of being required to make a case-by-case submission to some government authority.

(i) The role of law. Arbitrary decisions by officials or party functionaries destroy business confidence and make investment planning very difficult, whether the arbitrariness arises at top government level or in a junior district official. The authority to give orders has long been one of the privileges of officials in one-party States. A surrender of authority (i.e. to the rule of law, to the terms of a contract, or simply to the market) is not always made readily.

(j) Integrity in the public service. A reputation for corruption will actually kill off the prospects of certain businesses - a good example would be certain countries' meat exports which remain unacceptable in the United States of America, the European Economic Community and Japan because everybody knows that a certificate of hygiene can be purchased from some public official whatever the state of the local abattoir.

(k) A reasonable banking and financial system. In no other sector is suitably regulated competition more important for the foreign investor (and indeed for the domestic investor as well) than in the provision of financial services. A monopoly commercial banking service controlled by government gives little incentive to a modern, efficient service, and almost inevitably leads to officials allocating credit on other than purely commercial grounds.

(l) The reliability of domestic suppliers and subcontractors. When the foreign investor is expected to source inputs from domestic producers, particularly if they are parastatals and monopoly suppliers, it is vital that those producers supply promptly, competitively, and meet the required quality.

(m) The power of State marketing organizations (SMOs). A legal requirement to sell final output to or through an SMO will often act as a deterrent. Many SMOs have a poor reputation for efficiency, incorruptibility and prompt payment. In addition, this requirement makes brand name establishment more difficult and removes from the investor the commercial rewards that might be expected from achieving a higher quality of product than other producers.

(n) Protective tariffs which are not excessive. High tariffs might initially offer comfort to the prospective investor, especially if part of his output is to be sold on the domestic market. However, businessmen have learnt that such tariffs embody two dangers: first, that domestic suppliers may supply inputs (equally protected) of low quality and high cost; secondly, that any eventual dismantling of the protective apparatus - e.g. as part of IMF/World Bank conditionality - may leave the investor's own project unprepared for foreign competition.

(o) Protection of intellectual property rights. Foreign investors will be reluctant to bring in new technology in the absence of such protection and where there is no acceptance of the obligation to pay fair royalties for the use of intellectual property.

(p) Adequate personal security and reasonable educational and health facilities. Whether provided by the host country's public or private sector, quality in this area has an important influence on managements' decisions concerning business location.

VI. The wider context

The main criticism of the Guidelines is that the authors have interpreted their task too narrowly and that accordingly their guidance is timid and, in places, ambiguous. No less than 253 bilateral investment treaties, 23 multilateral instruments, and 48 foreign investment codes were examined.[9] The result of that mountainous labour is a minimalist document addressing mainly concerns that were more pressing yesterday than they are today.

However, there is one area where criticism would come down on the opposite side. The Guidelines assume (but do not argue) that virtually all FDI is beneficial and that most attempts by host States to impose conditionalities or performance criteria upon FDI are likely to prove counter-productive. It was not ever thus. Lord Keynes, who played such a large role in founding the Bretton Woods institutions, once wrote: "Ideas, knowledge, science, hospitality, travel - these are the things which should of their nature be international. But let goods be homespun wherever it is reasonably and conveniently possible, and, above all, let finance be primarily national".

Following a period of mutual distrust between many host States and TNCs in the 1960s and 1970s, and the excessive commercial bank lending to sovereign Governments of the 1970s, the pendulum has now swung firmly in favour of FDI in the private sector as "the main engine of growth". Likewise, the need for deregulation, and of export promotion rather than import substitution is recognized. The approach of the three General Counsels involved in the Guidelines reflects the current mood. However, these are matters of political economy rather than law, and it is not clear whether the General Counsels have any special expertise in this area. It is the nature of pendulums to swing back also, and so some correction to current enthusiasms will almost certainly prove necessary.

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[9] See "Progress report on the 'Legal Framework' for the treatment of foreign investment" in Presentations to the 43rd Meeting of the Development Committee, Washington, D.C., 28 April 1992.

In particular, host States would be well advised to exercise prudence before offering a too uninhibited welcome to all TNCs. Although some of the most successful developing economies (such as the Republic of Korea and Taiwan, Province of China) have recently relaxed their regulations on inward FDI, it is nevertheless true that during the years of their rapid economic expansion, and before their own productive and managerial structures matured, restrictions on inward FDI were applied. It is possible to argue that other developing countries were not so much wrong in maintaining restrictions and insisting upon performance criteria as misguided (or unrealistic) in the restrictions they tried to impose or the performance criteria they tried to enforce.

The desire to give a greater role to the private sector in most developing countries is matched by an equally strong desire to ensure that, in so doing, the domestic private sector does not become dominated by foreign players allowing no room for the growth of indigenous enterprises. It is a perfectly legitimate aim of political economy to encourage the development of major national companies or even of regional TNCs, and to aim to conduct policy so that external TNCs contribute to this end rather than frustrate it. Further refinements to the conditions under which major TNCs are admitted to developing country markets might therefore be expected. Such conditions would selectively include provisions relating to: (a) local content; (b) export targets; (c) local ownership; (d) training obligations; (e) progressively greater indigenous representation in senior management; (f) technology transfer; (g) some restrictions on access to local credit markets.

The same bland, over-simplified approach has led to the neglect of another issue, which is the potential conflict between countries already exporting manufactures (such as clothing) using semi-skilled labour into industrialized countries and those that would like to attract FDI in order to do so, undercutting existing suppliers in order to procure market access. This raises many questions about the effect upon the pattern of employment and upon the average level of wage remuneration worldwide of encouraging FDI with minimal performance requirements. It is a topic which cries out for further research. The example of Costa Rica suggests that insistence on appropriately designed performance criteria, when combined with political stability, respect for the integrity of contracts, and efficient health care, may actually improve the climate for FDI.

VII. Governance and the world economy

It is a truism that most FDI occurs as a result of the investing company's aim to increase or protect its profit. There may be other considerations, such as gaining access to new markets or technologies, protecting sources of raw material, or denying advantages to potential competitors. However, in the longer run, all of these may be seen as components in a strategy whose main driving force is maximization of the investing company's profit. It follows that ascertaining that conditions exist which make possible the creation of a valuable asset and the earning of profit logically come before concerns about the terms of admission of foreign investment, general standards of treatment, possible expropriation or contract alteration, and mechanisms for the settlement of disputes.

Although such matters may be held to reside outside the terms of reference set by the Development Committee for the task force, members of the Group of 24 may care to draw attention to actions by the international financial institutions and by OECD Governments which could improve the potential profitability of sustainable and beneficial FDI in many of the least advantaged developing countries.

The task force has codified part of what may be said to constitute developing country good governance towards the foreign investor. To restore symmetry to the Development Committee's approach, members of the Group of 24 may also want to discuss what better governance of the world economy could do to bring about fairer conduct in international economic relations and thereby a more favourable economic climate for FDI in developing countries generally. Any such discussion would need to deal, *inter alia*, with the following items:

(a) World interest rates that push up the required rate of return on developing country projects to a level that severely reduces attractive investment opportunities;

(b) An external debt overhang (with an increasing proportion of it being owed to the international financial institutions) that will clearly impede the ability of many of the poorer developing countries to allow the free remittability of interest or profits;

(c) The dumping of farm surpluses grown under subsidized price regimes onto international markets in a manner that damages the prospects (and often destroys the profitability) of tropical producers;

(d) Other practices among OECD Governments having the effect of lowering the price of developing country commodity exports;

(e) Increased protectionism in the form of non-trade barriers against many developing country manufacturers.

THE UNITED NATIONS CONFERENCE ON ENVIRONMENT AND DEVELOPMENT: AN OVERVIEW

Nurul Islam

Executive Summary

The United Nations Conference on Environment and Development (UNCED) reconfirmed that the central concerns of the developing countries are acceleration of socioeconomic development and eradication of poverty. That growth, poverty alleviation, population policy and environmental protection are mutually reinforcing and supporting has been recognized in Agenda 21, the action plan set for UNCED. For mutually beneficial interaction appropriate policies, technology, investment and institutions will be needed.

The distinction between environmental issues confined within national borders and those which extend beyond national borders was made clear at the Conference; less clear was the distinction between reversible and irreversible environmental degradation. UNCED paid close attention to the controversies surrounding global or cross-border environmental problems. Two conventions - one on global warming and another on biodiversity - were signed. The United States did not sign the convention on biodiversity. GATT negotiations on intellectual property rights have been closely linked to the success of the convention on biodiversity. A statement of principles on forests was agreed upon, with the door kept open for reconsideration at a later date of the possibility of a more legally binding instrument.

Although those issues of environmental degradation falling overwhelmingly within the national borders did not draw much of the limelight, they have nevertheless been incorporated into Agenda 21 in great detail. The environmental problems of primary concern to developing countries such as water pollution, air pollution, deforestation, desertification, soil erosion, etc. have received careful consideration.

While markets and prices free from distortions can contribute to environmental improvement, the role of interventions in the market to deal with externalities has also been recognized by the Conference.

Environmental protection would require large increases in investment: estimated by UNCED at $600 billion annually. Of this, the external resource requirements would amount to $125 billion per year. The role of the Global Environment Facility (GEF) will be very important for financing projects with global implications. It seems unlikely that the flow of external resources for developing countries would be without conditionalities, however.

The Conference has emphasized that environmental problems cut across various sectors of the economy, ranging from agriculture and industry to transport, energy and services. National capacity in developing countries to assess the environmental impact of projects and policies and to formulate multi-sectorial strategies must be greatly strengthened.

UNCED was the largest United Nations conference ever held, and was attended by the greatest number of heads of State from both developed and developing countries. It marked a watershed in the evolution of international thinking not only on environment but also - and this point is the most critical for the developing countries - on the interrelationship between poverty, growth, and environmental degradation. A consensus was reached on how these triple concerns are synergistically related.

The Conference ended with the Rio Declaration on Environment and Development, the Agenda 21 Action programme, and a Statement of Principles on Forests. While none has constituted a legally binding commitment, these texts did set the priorities and principles whereby progress towards environmentally sustainable economic growth would be measured. The legally binding commitments were incorporated into two conventions: one on climate change and another on biodiversity. Negotiated prior to the Conference they were signed by the participating Governments in Rio de Janeiro. Indeed, each of these conventions was signed by about 153 governments.

I. The Rio Declaration on Environment and Development

The Rio Declaration emphasizes that "human beings are at the centre of concerns for sustainable development and are entitled to a healthy and productive life in harmony with nature" and that eradication of poverty is an indispensable requirement for sustainable development, in order to decrease the disparities in the standards of living and better meet the needs of the majority of the peoples of the world."

On inter-generational equity, it stresses the need to "equitably meet the developmental and environmental needs of present and future generations."

On cross-border or international externalities, the Convention affirms that, while States have the sovereign right to exploit their own resources, "the activities within their jurisdiction must not cause damage to the environment or areas beyond the limits of their national jurisdiction. The environmental costs should be internalized, and economic instruments should be used on the assumption that the polluter should in principle bear the cost of pollution and trade policy measures for environmental purposes should not create arbitrary or unjustifiable discrimination or disguised restrictions on trade." Environmental measures that deal with transboundary or global problems should as far as possible be based on international consensus.

Lack of complete scientific certainty should not be used as a reason for postponing measures to prevent environmental degradation. The Montreal Protocol on Substances that Deplete the Ozone Layer recognized the high risks of delaying action while awaiting completely certain scientific verification. As the environmental degradation problem worsens, but no action is taken because there is no firm quantifiable scientific evidence, it may be too late by the time the latter is available, and the consequences may be disastrous. Frequently, as in the case of global warming, preventive policies regarding energy use are both efficient and environmentally friendly and at the same time do not reduce growth in the long run. Close monitoring of developments, on the one hand, and precautionary action, on the other, are wise policy choices in the absence of complete certainty.

The Rio Declaration urges both developing and developed countries to eliminate unsustainable production and consumption patterns and promote appropriate demographic policies. At the same time, the developed countries "acknowledge their responsibilities in pursuit of sustainable development in view of the pressures their societies place on the global environment and of the technologies and financial resources they command."

II. Agenda 21

The principles enunciated in the Rio Declaration and many other areas of concern where environment and economic development interact have been elaborated in Agenda 21 along with follow-up programmes of action. Action-oriented proposals in Agenda 21 are divided into 40 chapters and more than 100 programme areas. There are four sections as follows: social and economic dimensions of sustainable development; conservation and management of resources for development; strengthening the role of major groups; and means of implementation. The first section mentioned covers programmes relating to international cooperation to accelerate sustainable development in developing countries and related domestic policies; combating poverty; changing consumption patterns; demographic dynamics and promoting sustainable human settlements; and integrating environment and development decision-making.

The chapter on international cooperation deals with the relationship between international economic relations, the economic policies of individual countries, and sustainable development. The four programmes in this chapter - promoting sustainable development through trade liberalization; making trade and environment mutually supportive; providing adequate financial resources to developing countries and dealing with international debt; and encouraging macroeconomic policies conducive to environment and development - highlight two major points worthy of emphasis: (a) in the context of external indebtedness, the need to provide additional financial resources to developing countries and assure their efficient utilization; and (b) in developed countries continuing policy reform and adjustment to support the transition to sustainable development both domestically and in developing countries.

The chapter on combating poverty addresses the need to eradicate poverty and hunger and to manage natural resources sustainably by designing environmental policies that take into account those who depend on natural resources for their livelihood. The single programme area under this chapter is entitled "Enabling the Poor to Achieve Sustainable Livelihood." Among the issues addressed is family planning, although the term itself is not used. There is a call for the implementation, as a matter of urgency, of measures to ensure that "women and men have the same right to decide freely and responsibly on the number and spacing of their children and have access to the information, education and means to enable them to exercise this right in keeping with their freedom, dignity and personally held views, taking into account ethical and cultural considerations." This formulation, repeated in the chapter addressing human health, had been among the most difficult on which to reach a compromise during the negotiations.

The chapter on demographic dynamics and sustainability outlines three programme areas: developing and disseminating knowledge concerning the links between demographic trends and factors; sustainable development taking into account demographic trends and factors; and implementing integrated environment and development programmes at the local level, taking into account demographic trends and factors.

The chapter on changing consumption patterns was one that elicited controversy. It is concerned with changing unsustainable patterns of production and consumption which lead to environmental degradation, aggravation of poverty, and imbalances in the development of countries. The conference faced a North-South confrontation on the issue of population growth in developing countries, on the one hand, and consumption in developed countries, on the other. The developed countries wanted a commitment by developing countries to slow down population growth as a major policy instrument to contain or reduce environmental stress or pressure on natural resources. The developing countries countered with a demand that the developed countries undertake to reduce their per capita use of scarce natural resources, which are consumed at a rate which is several times higher in the latter than in the former. In view of the fact that the issue of population growth and related policies have been and are being debated in other international and United Nations fora, this confrontation seemed unnecessary. Moreover, in recent years support for population policies in developing countries has increased. However, despite increasing awareness of the problem of high population growth, policies and programmes have not been strong enough or successful enough in all countries. In many developing countries population policies combined with socioeconomic development have resulted in a decline - sometimes a significant decline - in the fertility rate. In others, there has been a much slower decline or a persistently high growth rate. However, international fora for deliberating on and strengthening such commitments exist (UNFPA, the United Nations Population Commission, *et al.*) whereas no comparable forum exists to debate excessive use of natural resources in developed countries and the impact on environmental degradation. Unless a change in the technology and consumption pattern reduces the rate of growth in developed countries, the continuation of past trends will put great pressure on natural resources. The compromise at the conference was to tone down the reference to the population issue and refer to over-consumption in both developed and developing countries, especially over-consumption on the part of the rich in developing countries. The programme of action addresses the excessive demands and unsustainable lifestyles among the richer segments everywhere, both in developed and developing countries. They are placing stress on the environment while the poor are unable to meet their basic needs for food, health care and shelter.

The chapter on protecting and promoting human health links health to environmental and socioeconomic improvement. It contains action programmes to meet basic health needs, control communicable diseases, protect vulnerable groups, meet urban and rural health challenges, and reduce health risks from environmental pollution and hazards.

The chapter on promoting sustainable human settlements is concerned with the cities of industrialized countries and settlements in developing countries that need more raw material, energy, and economic development in order to overcome basic economic and social problems. It includes such action programmes as national strategies for providing shelter; an international network of trained urban managers equipped to plan for human, environmental, and infrastructural demands; and reduction of migration pressures on cities by creating employment in rural areas.

The chapter on integrating environment and development in decision-making deals with the importance of integrating environmental factors into national policy making, law, economic instruments and national accounting.

The section on conservation and management of resources for development contains the largest number of chapters: protection of the atmosphere; integrated approach to planning and management of land resources; combating deforestation; combating desertification and drought; sustainable mountain development; sustainable agriculture and rural development; conservation of biological diversity; environmentally sound management of biotechnology; protection of oceans; protection of the quality and supply of fresh water resources; environmentally sound management of toxic chemicals, hazardous wastes, solid wastes, and radioactive wastes.

The chapter on protection of the atmosphere contains recommendations on: energy development, efficiency and consumption; transportation; industrial development; and prevention of stratospheric ozone depletion and transboundary atmospheric pollution. It emphasizes that much of the world's energy is produced and used in ways that would not be sustainable if technology were to remain constant and if overall quantities were to increase substantially. Control of atmospheric emission of greenhouse and other gases and substances will increasingly need to be based on efficiency and on a growing reliance on environmentally sound energy systems, particularly new and renewable sources of energy.

Regarding desertification and drought, the United Nations General Assembly was urged to establish at its next regular session an intergovernmental negotiating committee to elaborate an international convention to combat desertification, particularly in African countries, with a view to finalizing such a convention by June 1984.

Regarding protection of the oceans, the Conference also recommended that the United Nations General Assembly convene a conference to identify and assess existing problems relating to the conservation and management of border-straddling and migratory fish stocks as well as to consider means of improving international cooperation on fisheries. Such a conference should be consistent with the provisions of the United Nations Convention on the Law of the Sea.

On the issue of combating deforestation, the Conference recommended that governments "consider the need for and the feasibility of all kinds of appropriate internationally agreed arrangements to promote international cooperation on management, conservation and sustainable development of all types of forests including afforestation, reforestation and rehabilitation." This was a compromise statement to balance the concerns of timber-exporting countries such as Malaysia and those of industrialized countries that were eager to negotiate a legally binding instrument. Instead of a forestry convention, there is an agreement on a broad set of principles. Countries have decided to keep these principles under assessment for adequacy with regard to further international cooperation on forest issues.

The protection of the quality and supply of fresh water resources is of great importance to both developed and developing countries. This chapter emphasizes the importance of effective integrated management of water resources for all socioeconomic sectors relying on water. The action programmes include integrated water resources development and management; water resources assessment; protection of water resources, water quality, and aquatic ecosystems; drinking water supply and sanitation; water and sustainable urban development; water for sustainable food production and rural development; and impacts of climatic change on water resources.

The chapter on sustainable agriculture reflects growing concerns about sustainable agriculture in the light of the link between environmental degradation and the problems of hunger, agricultural supply, and trade and price support programmes. It seeks a comprehensive integration of criteria for environmentally sound management practices in all aspects of food and agriculture. The action programme includes agriculture policy review; people's participation; improvement of farm production and farming systems; land resource planning, information and education; land conservation and rehabilitation; water for sustainable food production and rural development; conservation and sustainable use of plant and animal genetic resources; integrated pest management; sustainable plant nutrition; rural energy transition; and evaluation of the effects of ozone depletion on plants and animals.

Most of the recommendations on conservation of biological diversity and many closely related issues of biotechnology have been covered in the convention on biological diversity. With respect to biotechnology, some of the action programmes in Agenda 21 covered: increasing the availability of food, feed, and renewable raw material; improving human health; protecting the environment; developing international mechanism for cooperation; and establishing mechanisms for the development and environmentally sound application of biotechnologies.

On the subject of strengthening the role of major groups, Agenda 21 has placed a great deal of importance on the participation of various groups in society in the decision-making process as well as in the implementation of environmental policies and programmes. The groups specifically identified are: women, youth, indigenous peoples, non-governmental organizations, local authorities, trade unions, business and industry, the scientific and technological community, and farmers.

The section on means of implementation includes such chapters as financial resources and mechanisms; transfer of environmentally sound technology; cooperation and capacity build-up; science for sustainable development; promotion of education, training and public awareness; natural mechanisms and international cooperation for capacity-building in developing countries; international institutional arrangements; international legal instruments; and mechanisms and information for decision-making.

On the transfer of and cooperation on environmentally sound technology, the three most important issues dealt with were: (a) terms of transfer, (b) international business as a vehicle for technology transfer, and (c) abuse of intellectual property rights in the case of privately owned technologies. The text related to international business as a vehicle for transfer of technology addressed the availability of "proprietary technology" through commercial channels, stating that while concepts and modalities for assured access to environmentally sound technologies continue to be explored, enhanced access to such technologies should be promoted, facilitated and financed as appropriate. On the issue of intellectual property rights Agenda 21 stressed that "in compliance with and under specific circumstances recognized by the relevant international conventions ... States should undertake measures to prevent the abuse of intellectual property rights, including rules with respect to their acquisition through compulsory licensing, with the provision of equitable and adequate compensation."

On international institutional arrangements for overseeing the implementation of Agenda 21, the emphasis was on the mandate and operations of the United Nations Commission on Sustainable Development. It was agreed that this Commission would report directly to the Economic and Social Council of the United Nations, which would in turn organize a periodic review of its work as well as that of all United Nations system-wide activities to integrate environment and development. The Commission will be constituted as a subsidiary body of ECOSOC, the membership of the Commission will be limited to no more than 52 members elected with due regard to equitable geographical distribution. The Commission will consider reports or periodic communications from the Governments and provide information on progress made with implementation of environmental conventions.

On the subject of international legal instruments and mechanisms, the important issues are: use of environmental standards as barriers to trade, compliance with international agreements, prevention of deliberate destruction of the environment, negotiation of a nuclear safety convention, and dispute prevention. On safe nuclear energy, efforts will be pursued to conclude the ongoing negotiations for a nuclear safety convention in the framework of the International Atomic Energy Agency.

On the trade and environmental issue, Agenda 21 observed that "States recognize that environmental policy should deal with the root cause of environmental degradation, thus preventing environmental measures from resulting in unnecessary restrictions to trade." Should trade policy measures for enforcement be deemed necessary, the following principles and rules should apply: non-discrimination; choice of least-restrictive trade measures; transparency in the use of trade measures; and the need to give consideration to the special conditions of developing countries.

III. Leading environment and development issues

Agenda 21, as summarized above, covered all possible issues relating directly or indirectly to the environment in the context of promoting social and economic growth with an accent on poverty alleviation. Many of these issues are matters of ongoing discussion and, in some cases, international negotiations and agreements in various international fora, both within the United Nations and beyond. Agenda 21 serves the purpose of reemphasizing the issues which are under discussion elsewhere and drawing renewed attention to them in the context of environmentally sound development strategies. As a result, it may stimulate or expedite action in other fora.

It deals with national as well as with cross-border international environmental issues; it specifies action programmes at both the national and international levels to resolve environmental problems in both domains.

Among the wide range of global issues relating to the interaction between environment and development, requiring action at the international level, a few that sparked vigorous debate and controversy included: mechanisms for meeting the financial costs of implementing Agenda 21 in developing countries; conservation and sustainable development of forests; preservation of global biodiversity; and the threat of global warming.

A. Financial resources and mechanisms

With respect to financing the incremental costs of environmental protection, a distinction was made between global and national environmental problems. External assistance for meeting national environmental needs was placed in the same category as traditional development assistance, whereas external resources used for meeting global problems were not in the same category. The costs of addressing global environmental issues may be considered as payments for environmental services provided by the developing countries. The location of investment is decided by the criterion of their effectiveness in meeting global needs.

The Secretariat of the Conference estimated the average annual resource requirements for the period 1993-2000 of implementing in developing countries the activities in Agenda 21 to be over $600 billion, including about $125 billion on grant or concession terms from the international community.[1] These figures have not been reviewed by Governments. Actual costs will depend upon, *inter alia,* the specific strategies and programmes to be implemented. The Conference confirmed that funding should be provided in a way that maximized the availability of new and additional resources and used all available funding sources and mechanisms including, among others, multilateral banks and funds; IDA; regional and sub-regional development banks; the Global Environmental Facility; relevant specialized agencies; other United Nations bodies and international organizations; multilateral institutions for capacity-building and technical cooperation such as UNDP, UNEP, etc.; bilateral assistance programmes; debt relief; and private funding. Higher levels of foreign direct investment should also be encouraged through national policies that promote such investments.

The developing countries emphasized the need for additional resources for the implementation of Agenda 21, i.e. additional in the sense of being over and above the development assistance otherwise expected to be available. According to past experience, whenever there is a new issue or area of development assistance or the emergence of countries requiring additional assistance, such as in Africa during the 1970s and 1980s, resources are diverted from existing programmes or recipients. Recent studies indicate that resources provided to new action programmes or new aid recipients represent a diversion to the extent of 67 per cent while new assistance accounts for 33 per cent.[2] Two mechanisms can help minimize the risks of such diversion: (a) a separate window for environment could be established in both bilateral and multilateral aid mechanisms with the provision that accounting and monitoring of the flow of resources through it should be totally independent of that for traditional development assistance; (b) another way of ensuring additionality would be to devise new sources of revenue and to assign them to environmental programmes. If, for example, new sources of financing such as a tax on energy, air transportation, or the like were devised and the proceeds allocated to a special fund for environmental purposes, it would likely be additional. In view of the reluctance of most sovereign States to surrender revenue-raising functions to a supra-national authority, this may be best done by countries imposing and collecting the tax proceeds for a separate national fund for environmental purposes that would provide assistance either bilaterally or through multilateral organizations.

The three issues that emerged as the most controversial in the course of the negotiations on financial mechanisms were the Official Development Assistance for Agenda 21, the replenishment of IDA, and the Global Environmental Facility and associated conditionalities.

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[1] United Nations Conference on Environment and Development (A/Conference/151/L.6), 13 June 1992.

[2] S. Collins, "Aid, allocation and availability: capital flows to developing countries?", World Bank Annual Conference on Development Economics, 1992.

On the first issue, several developed countries contended that much new and additional funding would be neither grant nor concessional finance but could take the form of private investment or official debt alleviation. The developing countries wanted a renewed commitment to the old United Nations target of 0.7 per cent of GNP to be provided by developed countries as official development assistance (ODA). The target of 0.7 per cent of GNP for ODA was not accepted by all developed countries.[3] The final text represents a compromise among the various developed-country donors and read as follows: "Developed countries reaffirmed their commitments to reach the accepted United Nations target of 0.7 per cent of Gross National Product for official developmental assistance and to the extent that they have not yet achieved that target, agreed to augment their aid programme to reach it as soon as possible."

It was also suggested that new ways of generating new public and private financial resources should be explored: in particular, various forms of debt relief including greater use of debt swaps; economic and financial incentives and mechanisms; feasibility of tradable permits; new schemes for fund-raising and voluntary contributions through private channels, including non-governmental organizations; and the re-allocation of resources from military uses.

The second issue concerned replenishment of IDA.[4] IDA is one of the various existing funding sources and mechanisms used in particular for the poorest of the developing countries. The Ninth Funding Replenishment was set at $15.5 billion. To adjust for the expansion of the world economy and inflation, the Tenth Replenishment would be increased by approximately $2 billion, according to the proposal. There was a discussion regarding a possible increase of IDA over and above the correction in terms that would increase it by $5 billion; this was called the "Earth Increment". Of this amount, $1.5 billion was to come from the World Bank's interest income and $3.5 billion from developed-country donors.

A complication would arise, however, if the additional assistance were provided only through IDA: assistance to countries with per capita income of $700 or less would be restricted. How would the needs of other developing countries be met? Would the additional resources be made available through the World Bank proper or through the various Regional Development Banks? Unless a separate account was established in each case, it would be difficult to ensure that assistance for environmental purposes was additional. The compromise text removed any reference to "Earth Increment" and directed the "IDA deputies to give special consideration to the World Bank President's statement to the UNCED plenary in order to help poorer countries meet their sustainable development objectives as contained in Agenda 21." A few developed countries were concerned that if UNCED committed them to levels for the Tenth IDA Replenishment, it would limit or preclude options in ongoing negotiations in other forums. Others believed that it was unrealistic to set funding levels before reviewing the projects that IDA-10 would fund for environmental programmes and projects.

The Rio conference did agree that progressive implementation of Agenda 21 should be matched by the provision of substantial new and additional financial resources. The initial phase would be accelerated by substantial early commitments of concessional funding. The United Nations Commission on Sustainable Development, established to monitor the compliance with environmental goals, would also regularly review and monitor progress on achieving the target of 0.7 per cent of GNP for ODA, thus combining the monitoring of implementation of Agenda 21 with the review of available financial resources.

The developed countries and others in a position to help were urged to make initial financial commitments and report them to the United Nations General Assembly in the fall of 1992. At the same time, developing countries were to begin drawing up their national plans to give effect to the decisions of the Conference.

Agenda 21 confirmed that the Global Environmental Facility (GEF) was designed to achieve global environmental benefits. GEF should cover the agreed incremental costs of relevant activities under Agenda 21, particularly for developing countries. At present, those countries receiving assistance through GEF must have a per capita income of $4,000 or less. There was also a need for agreement on the definition of "incremental costs of relevant activities under Agenda 21." At present only four categories of activities are covered by GEF. According to the decision of the Conference, the coverage of GEF is to be extended. This action needs to be more appropriately defined. If it is extended to cover all the global aspects of activities under Agenda 21, resource requirements would greatly increase.

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[3] While the Netherlands, Denmark and France support 0.7 per cent of GNP for ODA by the year 2000, the United Kingdom and Germany do not. The United States and Switzerland do not accept even the target of 0.7 per cent as such. Although Japan and the United Kingdom, for example, do accept the target, they have not agreed to a timetable such as the year 2000; other countries have agreed to both the target and the timetable.

[4] L.T. Preston, "Reducing poverty and protecting development: a call to action", United Nations Conference on Environment and Development, 4 June 1992.

Several modifications in GEF were suggested by Agenda 21. They are as follows: encouragement of universal participation; sufficient flexibility to expand the scope and coverage to relevant programme areas of Agenda 21; a system of governance that is transparent and democratic in nature, including terms of decision-making and operations; new and additional financial resources on a grant and concessional basis, particularly to developing countries; predictability in the flow of funds by contributions from developed countries, taking into account the importance of equitable burden-sharing; access to and disbursement of the funds under mutually agreed criteria without introducing new forms of conditionalities. All these various provisions broadly agreed upon at the Rio Conference will have to be negotiated for detailed elaboration and implementation in the coming years. The question of how to ensure an equitable burden-sharing in the flow of funds from developed countries remains undecided. The contributions to the United Nations budget follows one criterion, whereas those to the IMF and the World Bank follow other criteria. There have been suggestions that the GEF funds might also be used to finance national environmental problems such as the lack of clean water or regional blights such as desertification. The consensus seems to be that existing bilateral and multilateral or regional development institutions should finance such efforts.

A related point raised was that GEF should not finance but support the national environmental priorities of beneficiary countries. The national environmental action plans were intended to formulate national priorities. It was suggested that GEF should deal with the global aspects of the priority problems identified in national action plans. In other words, those global problems closely linked to national environmental priorities would receive more attention from GEF.

In extending the coverage of GEF, a relevant concern is the relationship between the facility and the various global environmental conventions, such as those on climate change or biodiversity. A central issue would be how to avoid loop-holes whereby the facility might fund projects in countries that did not sign or were not in conformity with the relevant conventions.

Agenda 21 refers to a democratic decision-making process. An efficient mechanism needed to be found that would avoid crippling GEF with micro management and constant recourse to ballots to be exercised by member countries. Most Governments agreed that the best approach was decision-making by consensus, with recourse to some form of majority voting only as a last resort. In the developed countries it was felt that the democratic decision-making process incorporated into the Montreal Protocol had not been very successful.[5] It was suggested that broader representation would improve the effectiveness of the facility. Lowering the entry fee of $5.5 million for developing countries might help, as would devising a formula for other contributors that reflected their ability to pay.

The issue of conditionality in the commitment of resources by GEF was hotly contested by developing countries. The compromise formulation stated that access to and disbursement from GEF would be on the "mutually agreed criteria" without "new forms" of conditionality. The deliberate vagueness in this formulation reflects, on the one hand, the desire to avoid new forms of conditionality and, on the other hand, the implication that there would be "mutually agreed criteria" for access to and disbursement of funds. "Mutually agreed criteria" and new forms of "conditionality", in practice, have often been very hard to distinguish. After all, the so-called "conditionality" in the World Bank or other bilateral or multilateral assistance programmes does not manifest itself particularly as "conditions" but as "mutual agreement between the donors and recipients."

Immediately prior to the Rio Conference, the governing body of GEF considered possible changes in coverage, functions and governance; a few principles were agreed upon by the participating countries in their meeting in April 1992 as indicated below. For example, it was agreed that GEF should provide additional and concessional funding of "agreed incremental costs" for achieving "agreed global environmental benefits." Incremental costs in this context were defined as the extra costs incurred in the process of redesigning an activity - vis-à-vis a baseline plan that was focused on achieving national benefits - in order to address global environmental concerns. GEF funding would thus cover that part of expenditures not offset by nationally appropriated benefits. Alternative assumptions - each reasonable - about baseline expenditures had been shown to result in a wide range of incremental costs. Since applying this principle unambiguously in practice has proved difficult, some flexibility in its interpretation would be called for.[6]

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[5] See *The Economist*, 30 May 1992.

The four areas currently covered by GEF - namely, global warming, biodiversity, international waters and ozone depletion - would remain; in addition, it was suggested that land degradation issues, primarily desertification and deforestation, as they relate to the focal areas of concern to the facility, would be eligible for financing.

If GEF is to act as a funding mechanism for environmental conventions such as those on biodiversity and climate change, it will be necessary to ensure that GEF focuses only on programming and implementation while at the same time the convention-specific priorities and criteria must be fully respected. An issue has been raised as to whether the principle of cost-effectiveness in addressing a targeted problem under GEF might not involve a combination of investment, technical assistance, and policy actions at the national and regional levels. The global environmental benefits may be influenced by existing national policies.

The interlinkages between global and national projects, on the one hand, and investment projects and policies, on the other, seem to raise all the issues involved in traditional financing of development projects. The "policy conditionality" that the developing countries reluctantly accept in the case of traditional development assistance may reappear in a different context and generate tension and disagreement. The main point emphasized by the developing countries, i.e. that the financing of global projects is not in the nature of traditional development assistance but rather constitutes a payment for environmental services provided by developing countries, may get lost in this process. This indeed poses a dilemma.

There is a need to formulate national environmental strategies and action plans. They are essential for the identification of environmental activities, both national and global; they will also provide a basis for coordination of various forms of development assistance. Moreover, non-governmental organizations and community groups are to play a role in bringing the needs and concerns of local populations to bear upon projects, including their identification, design, implementation (if feasible) and monitoring.

The April 1992 meeting of GEF also considered the issue of decision-making. Preference was given to the method of consensus rather than of voting. In cases when consensus was not reached, resort might be made to a voting system that would guarantee a balanced and equitable representation of the interests of both developing countries and donor countries. A simple majority vote or purely weighted system might not meet these considerations. An alternative way would be to require a simple or a special majority of the participants and a simple or a special majority of the financial contributors to GEF. However, this arrangement assumes that well over half of the participants would be from developing countries.[7]

B. *Forest principles*[8]

The Statement of Principles regarding forests presents a number of principles and elements intended to govern the management, conservation, and sustainable development of forests. Within national boundaries where deforestation takes place, it causes soil erosion, accentuates floods and droughts, and destabilizes watersheds. Deforestation has international or cross-boundary implications, inasfar as it contributes to global warming by reducing the "sink" for absorbing greenhouse gases and by causing a loss in biodiversity.

In recent years, international attention has been concentrated only on forests in developing countries, especially tropical rain forests. The statement emphasizes that "all types of forests are considered to embody complex and unique ecological processes which are the basis for their present and potential capacity to provide resources to satisfy human needs as well as environmental values." It points out the "sovereign and inalienable right of States to utilize, manage and develop their forests in accordance with their development needs and the level of socioeconomic development and on the basis of national policies consistent with sustainable development and legislation, including the conversion of such areas for other uses within the overall socioeconomic development plan and based on rational land use policies". This is in response to the reaction of the developing countries to the suggestion that policies for utilization of national forests should somehow be subject to veto by developed countries concerned about biodiversity and global warming.

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[6] See *Global and Environmental Facility: The Pilot Phase and Beyond*, UNDP/World Bank/UNEP, Working Papers No. 1, May 1992, p. 2.

[7] *Ibid.*, p. 7.

[8] Non-legally binding authoritative Statement of Principles for a Global Consensus on the Management, Conservation and Sustainable Development of all types of Forests, UNCED, June 1992.

The criteria and principles laid down in the statement apply to both developing and developed countries. For example, it states that "all countries, notably developed countries, should take positive and transparent action towards reforestation, afforestation and forest conservation, as appropriate." Furthermore, a comprehensive assessment of economic and non-economic values of goods and services obtained from forests and the environmental costs and benefits was urged. Also, sustainable forest management should be carried out on the "basis of environmentally sound national guidelines." In formulating them, account should be taken, as appropriate and if applicable, of "relevant international methodologies and criteria." The methodology and criteria, relative to different types of forests, specifically tropical rain forests, are still to be worked out and universally accepted by the scientific community.

Attempts should be made to incorporate environmental costs and benefits into market forces and mechanisms in order to promote forest conservation and sustainable development of forests. Accordingly, fiscal, trade, industrial, and transportation policies and practices that cause degradation should be avoided. The lack of alternative options available to local communities economically and socially dependent on forest resources has often stood in the way of sustainable use of forest resources. Therefore, intersectoral means should be employed to deal with the pressures and demands on forest ecosystems and resources arising from outside the forest sector.

The participation of local communities, indigenous people, non-governmental agencies, and forest dwellers, etc., should be encouraged in the development, implementation, and planning of national forest policies. They should be encouraged to "have an economic stake in the forest use" through, *inter alia*, those "land tenure arrangements which serve as incentives for the sustainable management of forests."

New and additional financial resources are needed to "sustainably manage, conserve and develop forest resources including afforestation, reforestation and combating deforestation and forest and land degradation." Research on, and development of, sustainably harvested non-wood products is to be promoted. The access to and transfer of environmentally sound technologies and corresponding know-how is to be provided to developing countries on favourable terms, including concessional and preferential terms.

The Statement likewise supports open and free international trade in forest products as well as better market access and prices for higher value-added forest products and their local processing; it opposes unilateral measures to restrict and/or ban international trade in timber or other forest products. In view of the recent publication of the World Bank's forest policy paper, it is appropriate to compare it with the Rio Statement. The World Bank's policy paper on forests emphasizes many of the principles contained in the Rio Statement on forests.[9] Examples are the need for participation by local communities in the development of agro-forestry and social forestry projects as well as the recognition of factors outside the forest sector that put pressure on the utilization of forest resources for fuel and other products. Similarly, regarding international trade in forest products, the general approach of the Bank's policy is the same as that of the Rio Statement.

However, in two respects, the Bank's policy is much stricter. One is in the matter of financing of commercial plantations and the other is the exploitation of tropical moist forests. With respect to exploitation of commercial plantations, the World Bank imposes a number of criteria. The basic condition is the "Government's commitment to sustainable and conservation oriented forestry," which includes policies and the institutional framework to ensure sustainable use; participation of local people and the private sector in the management of natural forests; comprehensive and environmentally sound conservation and development plans; social, economic, and environmental assessment of the forests; forest preservation to maintain biodiversity and safeguard the interests of forest dwellers; and institutional capacity to implement and enforce the above commitments. If these conditions are not met, the Bank operations are to be restricted to helping the countries to achieve these conditions. In the Rio Statement, these criteria are generally supported but are not set as prior conditions to be fulfilled before a country becomes eligible for external financing.

For tropical forests, a precautionary policy is followed by the World Bank; no distinction between tropical moist forests and other forests is made in the Rio Statement. According to the World Bank, there is (a) considerable uncertainty regarding the full evaluation of environmental services of tropical rain forests, (b) inadequate knowledge regarding their sustainable management, and (c) great irreversibility associated with their loss or degradation. Hence, the Bank will not undertake under any circumstances to finance commercial logging in a primary tropical moist forest. With a view to implementing this decision, the Bank will rely on the following measures. Infrastructure projects such as roads, dams, and mines leading to a loss of tropical forest will be subjected to vigorous environmental assessments; a greater emphasis will be placed on projects and programmes involving institutional development, forest protection measures, and non-forest income-generating projects; special attention will be paid to 20 countries that account for 85 per cent of tropical moist forests where forests are seriously threatened by encroachment and destruction. In these countries, economic development will have priority in poor and densely populated areas around the forest or in the original areas of forest encroachers.

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[9] World Bank, *Forest Policy Paper*, Washington, D.C., July 1991.

It is expected that the Rio Statement on forest principles will be only a first step towards reaching an international consensus on forests in the foreseeable future. Implementation of the Bank's policy on tropical rain forests before international consensus has been reached would be somewhat arbitrary and premature. For poor countries in dire need of income from tropical forest resources, pressure to prevent their exploitation should be accompanied by an international agreement to compensate them for having forfeited potential income.

C. *Biodiversity - issues and convention*

Global biodiversity includes diversity of biological species, genetic diversity of individual species and the diverse ecosystems within which they exist. There is considerable scientific uncertainty regarding the number of species that inhabit the earth. The estimated number is assumed to be in the range of 10 million.[10] The geographical distribution of biodiversity is uneven, with about two-thirds of all terrestrial species occurring in the tropics.

The genetic resources in the developing countries are considered especially valuable for their important medical and agricultural applications. Wild crops are often bred into cultivated ones in order to provide new varieties of seeds resistant to drought and disease. In industrial countries, the retail value of drugs derived from plants, estimated at $43 billion in 1985, could reach $47 billion by 2000, on the basis of 10 per cent of all plant species examined so far for their potential medicinal value.[11]

Threats to biodiversity are many and varied. They include: over-exploitation of biological resources; destruction of habitats; devaluation of traditional knowledge systems; neglect of primitive and rare plant varieties; extermination of wildlife; pollution and climatic change; and over-fishing and clear-cutting of forests.

If poorer countries are to have an incentive to conserve their biodiversity, they will have to earn a higher return from conservation than from alternative uses. The full economic cost of preserving biological diversity exceeds direct expenditures on protection and includes the costs of alternative uses of natural habitats. Increasing pressure on land resources raises the opportunity costs of conservation of natural habitats.[12] Countries at risk do not necessarily have an interest in protecting species diversity where the benefits are scarcely visible and accrue not only to the local population but to the people of the world.

The developing countries felt apprehensive regarding any international convention on biodiversity conservation:[13] such a convention might legitimize free access to biodiversity in developing countries in the name of information exchange and conservation; it might enable the developed countries to impose conditionalities on aid and trade programmes; it might allow the contentious part of the convention on climatic change to enter by the back door, i.e. conservation of tropical forests in the name of conservation of biodiversity to offset the high level of emissions of "greenhouse" gases in the developed countries.

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[10] *Conservation of Biological Diversity: Background and Issues*, Preparatory Committee for the United Nations Conference on Environment and Development, Working Group No. 1 (A/Conference/151/PC/66), August and September 1991, Geneva.

[11] See *The Economist*, 13 June 1992.

[12] At present $6-8 billion annually are spent worldwide on conservation in both developed and developing countries. No more than $200 million a year, or 3 per cent of the world's expenditure on conservation activities, constitute a transfer of resources to developing countries for conservation activities. World Bank, *World Development Report 1992*, pp. 167 and 175-178.

[13] R. Kothari, "Politics of biodiversity convention", *Economic and Political Weekly*, 11-18 April 1992.

The Convention requires that all countries undertake environmental-impact assessments of proposed projects with significant adverse effects on biological diversity and ensure that environmental consequences of programmes and policies with likely significant adverse impact on biological diversity be duly taken into account. The Convention on biodiversity recognizes the sovereign rights of States over their natural resources, including their authority to determine access to genetic resources subject to national legislation. Accordingly, "access to genetic resources shall be subject to 'prior informed consent' of the country providing such resources" and "shall be on mutually agreed terms". The recipient country "shall endeavor to develop and carry out scientific research based on such resources with the full participation of and, wherever possible," in the country providing them. Also, the latter will share in a fair and equitable way, on mutually agreed terms, the results of research and development and the benefits arising from commercial and other utilization of genetic resources.

According to the Convention, access to and transfer of technology to all developing countries, however, must be provided and/or facilitated under fair and most favourable terms, including concessional and preferential terms, where mutually agreed, and consequently with adequate and effective protection of intellectual property rights, in the case of technologies subject to patents and other intellectual property rights. The developing countries that provide genetic resources "shall be provided access to and transfer of technology which makes use of those resources, on mutually agreed terms, including technology protected by patents and other intellectual property rights".

As regards the relationship between transfer of technology and intellectual property rights, the following provisions need to be noted. First, the members shall design policy measures such that "the private sector facilitates access to, as well as joint development and transfer of technology for the benefit of both governmental institutions and private sector of developing countries." Moreover, the private biotechnology companies in the developed countries should share and jointly develop technology not only with the private sector but also with public institutions in developing countries. Secondly, in view of the impact of patents and other intellectual property rights on the implementation of the Biodiversity Convention, members must cooperate in this regard subject to national legislation and international law, in order to ensure that such rights are supportive of and not contrary to its objectives."

New and additional financial resources are to be provided by developed countries to enable developing countries to meet the agreed full incremental costs of implementing the obligations of the convention and to benefit from its provisions. These "incremental" costs are to be agreed upon between the developing countries and the financial institutional structure that is provided for in the convention, in accordance with the latter's policy, strategy, programme priorities, and eligibility criteria. An indicative list of incremental costs as well as the financial mechanism shall be established by the governing body of the convention. In the interim period, the Global Environmental Facility has been designated as the financial mechanism. The effectiveness of the financial mechanism, which will be "democratic and transparent" in governance, will be reviewed not less than two years after the entry-into-force of the convention and thereafter on a regular basis. The bilateral, regional and other multilateral channels, in addition to the mechanism established under the convention, shall also provide resources.

The extent to which developing countries effectively implement their commitments will be subject to (a) effective implementation by developed countries of their commitments related to financial resources and transfer of technology and (b) full recognition that economic and social development and eradication of poverty are the first and overriding priorities of the developing countries.

The refusal of the United States to sign the Biodiversity Convention rests on several grounds. First, apprehension that the biodiversity treaty might result in stricter standards for United States regulations under such laws as the Endangered Species Act. This is viewed by many groups as inimical to growth and business interests. Secondly, the issue of proprietary rights to drugs and other substances derived from species or even from the genes of species found in various countries. Customarily, whatever company from whatever nation that finds a way to exploit those materials retains the profits. Under the convention, if an American company developed a product from the genetic resources of a developing country without first reaching royalty agreements with that country, the country concerned would have the right to insist that the product remain its intellectual property. Hence, the United States felt that the Biodiversity Convention was in conflict with GATT negotiations over intellectual property rights and that the biotechnology and pharmaceutical industries within the United States would be adversely affected. Thirdly, biotechnologies developed from the resources of one country by a company in another country should be shared on a fair and equitable basis. The convention urges caution in the handling of genetically modified organisms and suggests the need for a future protocol to ensure that such organisms are rendered safe before releasing them.

D. Global warming

Considerable attention was given at the Rio Conference to the framework convention on climate change, a subject widely discussed at the international level in recent years. An international agreement on climate change was difficult to obtain for various reasons: change varies across countries; damage differs across countries even when climate change is similar, because of differences in ecology and economic activity; and countries differ in their contributions to emissions of gases causing the greenhouse effect.

The convention on climate change is based on the following international consensus: human activities are substantially increasing atmospheric concentrations of gases that lead to additional warming (additional to a natural greenhouse effect) of the earth's surface and atmosphere and may adversely affect national ecosystems and humankind; predictions of climate change, particularly with regard to timing, magnitude and regional distribution, are subject to many uncertainties; measures to address climatic change will be most effective if they are based on scientific, technical and economic considerations and are continually re-evaluated in the light of new findings; various actions can be justified (economically) in their own right and can help at the same time to solve other environmental problems; "the larger share of historically and current global emissions of greenhouse gases has originated in developed countries ..., per capita emissions in developing countries are still relatively low and the share of global emissions originating in developing countries will grow to meet their social and development needs." For developing countries to achieve sustainable social and economic development, their energy consumption will need to grow apace, taking into account possibilities for achieving greater energy efficiency. Countries should take "precautionary measures to anticipate, prevent or minimize the causes of climatic change and mitigate its adverse effects." The lack of full scientific certainty is no reason for postponing such measures, in case there are threats of serious irreversible damage. However, "policies and measures to deal with climatic change should be cost-effective so as to ensure global benefits at the lowest possible cost."

The convention seeks to stabilize concentrations of gases causing the greenhouse effect within a time-frame sufficient to allow ecosystems to adapt naturally to climate change, with a view to preventing threats to food production and enabling sustainable economic development. Thus, all countries (both developed and developing) must undertake the following commitments: (a) to develop, periodically update, publish and make available national inventories of emissions of all greenhouse gases; (b) to formulate, implement, publish and update national and, where appropriate, regional programmes to mitigate climatic change along with measures to facilitate adequate adaptation to climatic change; (c) to take climatic-change considerations into account in their relevant social, economic and environmental policies and actions; and (d) to promote and cooperate in (i) development, application and diffusion, including transfer of technologies, practices and processes that control emission of greenhouse gases; (ii) sustainable management, conservation and enhancement of sinks and reservoirs of all greenhouse gases; (iii) adaptation to the impacts of climatic change; (iv) scientific, technological, socio-economic and other research, (v) full, open and prompt exchange of relevant scientific, technological, and socioeconomic information; and (vi) education, training and public awareness, etc.

The developed countries and countries in transition to market economies must adopt such national policies and measures as would demonstrate that they are taking the lead in "modifying long term trends in emissions recognizing that the return by the end of the present decade to earlier levels of emissions would contribute to such modifications." This was intended to accommodate the United States, which, unlike other developed countries, was unwilling to accept targets or timetables for the limitation of greenhouse gases. Furthermore, the countries concerned would take into account (a) differences in their respective starting points and approaches, economic structures and resource bases, available technologies and other individual circumstances, including the need to maintain strong and sustainable economic growth, and (b) the need for equitable and appropriate contributions by each of these countries to the global effort. They may implement such polices and measures jointly with other countries.

All countries, developing and developed, would communicate to the "conference of the parties," which is the governing body of the convention, information related to implementation of the convention. The developed countries (including economies in transition) must communicate within six months of the entry-into-force of the convention, and periodically thereafter, detailed information on policies and measures as well as resulting projected emissions by sources and removals by sinks of greenhouse gases with the aim of returning individually or jointly to their 1990 levels. The developing countries would communicate their implementation within three years of entry-into-force of the convention or of the availability of financial resources to finance costs of measures to mitigate climate change by addressing emissions of greenhouse gases.

Methodologies for calculations of emissions by sources and removals by sinks of greenhouse gases should take into account the best available scientific knowledge and will be agreed upon by the governing body of the convention and reviewed regularly by it thereafter. Similarly, not later than one year after the entry-into-force of the convention, the adequacy of policies and measures adopted by the developed countries would be reviewed, and following the review, appropriate action taken, including modifications of policies and measures. A second review must take place not later than 31 December 1998.

The developed countries "shall provide new and additional financial resources" to meet the "agreed full costs" incurred by the developing countries for making an inventory of emissions of all greenhouse gases as well as to meet agreed full "incremental costs" of implementing measures covered under the convention. They would also assist those developing countries which were particularly vulnerable to the adverse effects of climatic change in "meeting costs of adaptation to these adverse effects". In the implementation of the commitments, consideration would be given particularly to countries that were highly dependent on income from fossil fuel or facing serious difficulty in switching to alternatives.

The developed countries would be called upon to take practicable steps to promote, facilitate, and finance, as appropriate, the transfer of or access to environmentally sound technologies and know-how to other countries, particularly developing-country parties, to enable them to implement the provisions of the convention.

Specific provisions incorporated into the convention would cover provision of financial and technical assistance to the developing countries. For example, the extent of effective implementation by developing countries of commitments under the convention would depend on the implementation of reciprocal commitment by developed countries relating to financial resources and transfer of technology. Secondly, the extent of their implementation would take fully into account that economic and social development and poverty eradication constitute the primary and overriding priorities of the developing countries.

Developing countries may, on a voluntary basis, propose projects for financing, including specific technologies and equipment, etc., needed to implement such projects, along with, if possible, an estimate of all incremental costs of the reductions of emissions and/or increments or removals of greenhouse gases as well as an estimate of the consequent benefits.

From its first session, the conference of the parties, i.e. the governing body, must arrange on request for the provision to developing countries of technical and financial support for (a) compiling and communicating information relating to both inventory and measures taken or envisaged, and (b) identifying the technical and financial needs associated with proposed projects and response measures under the convention.

IV. Conclusion

The United Nations Conference on Environment and Development reconfirmed that the central concerns of the developing countries are acceleration of socioeconomic development and eradication of poverty. These concerns should be kept in mind while formulating environmental policies, whether nationally or internationally. Environmental degradation aggravates poverty and poverty aggravates environmental degradation. Growth cannot be sustained for long if it is accompanied by either depletion of natural resources or degradation of the environment. An accelerated pace of economic growth without appropriate environmental policies and actions will adversely impinge on growth in future years. Inter-generational equity in the allocation of resources and in the distribution of benefits of development is critical in decisions regarding costs and benefits of environmental protection. That growth, poverty alleviation and environmental protection could be mutually reinforcing and supporting has been recognized in Agenda 21. What was needed for mutually beneficial interaction was appropriate policies, technology, investment and institutions.

The distinction between environmental issues that are confined within national borders and those that extend beyond national borders became clear at the conference; less clear was the distinction between reversible and irreversible environmental degradation. In the case of reversible degradation, the developing countries may be willing to suffer degradation at the present moment and restore environmental quality in the future, when their income increased, the pressure of present needs declined and resources and technology to deal with environmental degradation expanded.

At the Rio Conference, close attention was focused on the controversies surrounding global or cross-border environmental problems, i.e. negotiations on conventions on global warming and biodiversity figured in the headlines. Such issues involve international negotiation and allocation of costs and benefits among individual countries. Cross-boundary environmental problems affect different countries differently; also, their contribution to global environmental degradation varies widely. At the same time, the costs of mitigating environmental degradation have to be shared equitably. Regarding several important international or cross-border environmental issues of vital concern to developing countries, while no legally binding convention was reached, on some issues there was consensus that efforts in future would have to be made to reach an international agreement. These included an international instrument dealing with desertification, international water use and migratory and boundary-straddling fish stocks. A statement of principles on conservation and sustainable use of forest was agreed upon, and the door was kept open for its review and reconsideration at a later stage regarding the possibility of a more legally binding mechanism. The two conventions signed at Rio on biodiversity and global warming reflect difficult compromises. The most important industrialized country declined to sign the convention on biodiversity; one of the reasons given was its inconsistency within the ongoing negotiations on intellectual property rights despite the provision that obligations under it must be consistent with any further agreement on intellectual property rights. At present, the United States implements its own policy on intellectual property rights internationally through its own trade law, i.e. Super 301. This is a subject of controversy between the United States and the rest of the world. The developing countries must pay considerable attention to the final draft on intellectual property rights to be negotiated within the GATT.

With respect to the convention on global warming, the United States alone opposed any obligation regarding either a target date or a target amount for the reduction of emissions of greenhouse gases. However, the convention includes a timetable for the adoption of measures to reduce emissions, with projections of the levels of emissions resulting therefrom, which will be reviewed one year after the convention comes into force and for the second time in 1998. The developing countries have been given a longer time-frame for submission of information on the inventory of their greenhouse gas emissions as well as on measures to reduce them, recognizing that their use of fossil fuel will rise, consistent with their development needs. Their access to cleaner technology will depend on financial and technical assistance from developed countries. The convention places the major responsibility on the developed countries, which should clearly lead in reducing emissions. The developing countries will be provided assistance, first, in making an inventory of greenhouse gases and, secondly, in identifying measures and associated projects to reduce such emissions so that these projects can be submitted for financing by an international financial mechanism. For the time being, this mechanism is GEF.

The Statement on forests recognizes the need for development of "scientific methodology" for sustainable forest management because of considerable uncertainty and disagreement over this aspect; in addition, it provides that methodologies so developed need to be internationally agreed upon before countries are required or urged to implement them.

Even though the issues of environmental degradation predominantly confined within national borders did not attract the limelight, these concerns have been incorporated into Agenda 21 in great detail. The environmental problems of primary concern to developing countries, such as increasing water pollution and urban air pollution, deforestation, desertification and soil erosion have been given careful consideration, with programmes of action recommended for each area. None, however, has been incorporated into commitments that are legally binding. On all the issues a broad consensus has been recorded concerning the causes and consequences of degradation and the measures needed to mitigate or slow down the process. These measures include provision of health and sanitary facilities, pure drinking water and fair allocation of water among its multiple users, i.e. agriculture, industry and households, etc. in both urban and rural areas. Uses of energy, including renewable sources of energy, have likewise been addressed. Problems of urban settlements also drew considerable attention in Agenda 21.

In the context of Agenda 21, the alleviation of poverty in developing countries attracted renewed attention. During the 1980s, attention was focused on stabilization and structural adjustment measures rather than on growth and poverty alleviation. While the case for combining adjustment measures with those stimulating growth has long been recognized, poverty alleviation was neglected. Increased awareness of environmental concerns has put the environment-poverty nexus back on the agenda of the world community. Investments in health, education, sanitation and human settlements, population planning, etc., never received in practice, either in terms of effective policies or allocation of investment resources, the high priority they deserved. In spite of the controversy at UNCED on the role of population policy in developing countries for alleviating the pressure on resources resulting from over-cultivation, over-grazing, deforestation and soil erosion, etc., it formed a part of Agenda 21. The close interrelationship has been reemphasized between fertility and population growth, on the one hand, and socio-economic development, on the other, in particular, a decline in infant mortality, an improvement in the status of women, including higher levels of education for them, especially secondary education, and expanded income-earning opportunities, combined with the supply of family-planning services.

The Conference has helped to define the policies, institutions and technology needed for environmentally sustainable development in the years to come. Emphasis was placed on markets and prices, which, when free from distortions, could contribute to environmental improvement. The need for regulations and interventions in the market, wherever environmental problems cut across groups and nations, has been recognized, since markets cannot solve the problem of externalities, either across generations, groups within a country or across nations. It is not easy to correct the divergence between private costs and social costs of environmental degradation through taxes and subsidies. It is difficult to quantify the externalities and social costs of projects and programmes or to fine-tune the appropriate rates of taxes and subsidies, until correct prices prevail, without creating uncertainty and instability in the market. While it is recognized that the "polluter pay principle" can in many instances reduce the scope for environmental degradation, to devise mechanisms to implement such policies requires professional and administrative skill that is scarce in developing countries. An unexplored/unexploited measure is the endowment/specification of property rights so that bargaining takes place between the polluter and the polluted and compensation to those adversely affected is paid or the polluter undertakes to protect the environment.

Environmental protection would require a large increase in investment in order to introduce new technology over a wide range of economic activities, including agriculture, industry, transport, energy, etc. Investment requirements for soil and water conservation, new sources of energy, and afforestation are considerable. A great part of these investment resources will come from within the developing countries, from both the private and public sectors. Of the required estimate by the UNCED secretariat of $600 billion a year for environmental protection, only 20 per cent was recommended as the target for external assistance. External assistance will not be easy to obtain in view of the aid fatigue and competing demands for external resources from new claimants such as the CIS. Whether the external resources needed for environmental protection would be additional to traditional development assistance would depend on the ability to find new sources of revenue and on new mechanisms that can be established to monitor and ensure that the flows are genuinely additional resources - not a diversion of resources from existing purposes or recipients. The peace dividends seem to be unavailable in view of various political constraints in the developed countries. It is necessary to increase greatly the national and international pressure on the Governments of the world to reduce military expenditures in both developing and developed countries, in order to release resources to fight the war against environmental degradation.

The role of GEF is very important for financing projects with global implications. In this context, the concept of incremental costs incurred by developing countries for projects to confer global benefits assumes an important dimension. How to define incremental costs will be a tricky question, depending on the assumptions made regarding the baseline situation. Complications will mount if links between policies and national investments, on the one hand, and global projects, on the other, enter the picture. For some years to come, if the spirit of international cooperation, especially the confidence of the developing countries in this respect, is not to be shaken, it would be desirable and constructive to be less rather than more stringent in the provision of finance. It is interesting to note that the Convention on Biodiversity itself stipulates that the adherents themselves have to agree on what is meant by incremental costs.

With greater emphasis on both poverty alleviation and environmental protection, it seems unlikely that the flow of external resources for developing countries would be without conditionalities. Whether the resources would flow on "mutually agreed terms" or on mutually accepted conditions is quite irrelevant. What matters is that the developing countries would be increasingly required to fulfil the criteria needed for environmental protection. Agenda 21 can provide a framework for consensus on how additional resources should be channeled. In fact, in the two areas dealing with global environmental problems, i.e. conventions on biodiversity and global warming, it is stipulated that the extent to which developing countries can be expected to fulfil their commitments under these two conventions will depend on the extent to which developed countries fulfil their commitments to provide new and additional sources of finance.

An important consensus reached at the Conference was that environmental problems cut across various sectors of the economy, ranging from agriculture and industry to transport, energy and services. Hence, an assault on environmental degradation must be multi-pronged and multi-faceted, covering various sectors simultaneously. Soil erosion cannot be solved independently of the problem of livestock-grazing or crop-farming or pattern of use of inputs, including irrigation. Use of water for irrigation is not separate from use of water for industrial or household purposes. The availability of cheap energy or alternative sources of energy is linked to consumption of forests, stimulated by the demand for fuelwood in developing countries. Severe balance-of-payment constraints lead to a frantic search for alternative sources of foreign-exchange earnings, which in turn leads to the cutting down of forests and the over-exploitation of scarce natural resources. Environmental action plans for individual countries, which would assess the environmental priorities and formulate national programmes of remedial action, are desirable tools. At the same time, assessment of the environmental impact of projects is needed. This implies that developing countries would require a great deal of strengthening of national capacity in order to analyse environmental problems, to assess the environmental impact of projects and policies and to formulate multi-sectoral strategies for either preventing environmental degradation or mitigating its consequences.

The Rio Conference, if nothing else, has succeeded in raising awareness of environmental issues to a level and on a scale that is possibly unprecedented. Particularly striking has been the role of non-governmental organizations in raising awareness about environmental problems and forcing Governments and the private sector to pay attention. It is remarkable that in the United Nations Commission on Sustainable Development, intended to monitor the implementation of Agenda 21, non-governmental organizations will continue to play an important role.

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